BANKING REFORM

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BANKING REFORM

EDITED BY

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CHICAGO

THE NATIONAL CITIZENS' LEAGUE

FOR THE PROMOTION OF A

SOUND BANKING SYSTEM

1912

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For the Promotion of a
Sound Banking System

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PREFACE

THIS volume is intended to furnish a plain, untechnical exposition of the defects of our present banking and currency system, together with a discussion of the remedies. Not since the Civil War has the country been confronted with a monetary and banking question of greater importance to business prosperity. The adequacy of the banking system affects the everyday existence of the laborer, farmer and merchant. The unnecessary expense of obtaining credit under a bad banking system is borne by the borrower; the impossibility of getting loans in a time of panic shuts up factory and shop and falls most severely upon the wage-earner who loses his employment. Unemployment is largely increased by financial panics.

The reason for the existence of the National Citizens' League, which is made up of business men, is found in the fact that the reform affects the borrowing business man more than the lending bank; the bank can always protect itself by sacrificing the borrower. There is practically no class in the community not directly concerned in the outcome of this campaign of education. This book explains the effects of our banking system and of its reform on every class.

It has long been seen that our currency is needlessly inelastic; that our credit system is even more dangerously inelastic; that our large gold supply is ineffectively used; that the scattering of reserves forbids co-operative action by the banks in times of stress; that our rigid reserve system even breeds panics; that state banks and trust companies are doing commercial banking but without coöperation with national banks; that our Independent Sub-Treasury often attacks the reserves of banks at times of danger and works without business-like economy and efficiency; that idle funds of banks drift to New York and on call loans feed stock speculation; and that our trade is greatly hampered by lack of American banking facilities in foreign countries. For these reasons the people are calling loudly for legislation which shall be non-partisan and formed on seasoned experience, without breaking with our

democratic system of independent banks. It should also be a matter of care that elasticity should be obtained without the dangers of over-expansion.

The reform should not take the shape of a dominant central bank, nor should it be the creature of politics. For this reason the Government of the United States should not enter the discount and deposit business of banking; but, on the other hand, it should supervise and regulate a coöperative means of assistance, like an enlarged clearing-house association, in the common interest, and require the banks to pay all the cost of providing capital, supplying gold reserves, and issuing notes under its close supervision. Thus the surplus profits of note-issues and of discounts would go to the people of the United States. Moreover, in any legislation, care should be taken that control of our credit system should not pass into the hands of any sinister political or financial interests.

For these good and sufficient reasons, the National Citizens' League, organized in most of the States of the Union, is now carrying on a campaign of education so that the worth of every measure proposed to Congress may be rightly judged. For this reason the plan of the National Monetary Commission—the elaborate and most discussed plan before the public—has been given extended study. The League, however, is not committed to any specific measure. If discussion shows that any other plan is superior to that now before Congress, it will support that plan. It will favor any measure which incorporates its fundamental principles without regard to its origin. It realizes, however, that the remedy for the defects of our present credit system lies in some form of a coöperative institution, evolved from our clearing-house experience, by whatever name it may be called, which will remove the defects of to-day. The evil of separate sections, working at odds, can no longer be tolerated. The coöperation desired should be country-wide, providing for the importation of gold, in the interest of all banks, big and little, giving assistance to all in times of stress, and supplying uniformity in the rate of discount. Such advantages could not be gained by dividing the country into independent detached sections, leaving the situation much as it is to-day. But this coöperative agency should furnish the indispensable economy of united reserves and common places for the rediscount of commercial paper impossible under a system of separate organizations.

In the preparation of this volume, especial acknowledgment is

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J. Laurence Laughlin,
Chairman of the Executive Committee,
National Citizens' League.

Chicago, April 15, 1912.

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BANKING REFORM

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CHAPTER I

THE NATIONAL BANKING SYSTEM

§1. The National Banking System—Revising Banking Systems to Fit Changing Conditions—§2. Scope of the National Banking System and Capital Invested—§3. Chartering National Banks—Safeguards Against Banking Monopoly—§4. National Bank Note Issues, Their Restriction and Regulation—Inelasticity of Note System—§5. How Banks Are Classed Under the Reserve System—Regulations for the Independence of National Banks—§6. Relations of Banks to Each Other—§7. Duties of the Comptroller of the Currency—Co-operation Among National Banks Practically Impossible—§8. National Banks Only an Element in the Banking System—National Banks the Mainstay of the Whole Banking System—§9. Relation of the National Banks to the Government—§10. Defects of the National Banking System—§11. Remedy for the Defects.

§1. Organized in 1863, the national banking system has had a life of nearly fifty years. Within that period little has been done to alter its scope or constitution. The first enactment was modified in important particulars June 24, 1864, but the two measures may be considered substantially one. Subsequent innovations have been such as were necessitated by extraneous features of national policy—the redemption of the greenbacks, the refunding of the public debt from time to time, and others. Fundamentally, the plan of banking for which the system itself stands is what it was at the beginning.

Revising Banking Systems to Fit Changing Conditions

Few systems of banking can last for half a century without requiring substantial modification. The Canadian banking system is remodeled every decade, in pursuance of a requirement embodied in the fundamental law which governs it. The legislation of European countries is frequently revised and adjusted to current necessities. This is an unavoidable outgrowth of changing commercial conditions which call for changes in the legislative adjustments that control them. Today the national banking system presents serious problems to the commercial world. These call loudly for study and solu-

tion. Bill after bill has been presented to Congress within the past ten years, but of all this multitude of measures not one has received more than cursory study and none has ever been seriously considered as a practical question. It is for the commercial community to decide whether the present system shall be continued, or whether one better adapted to current needs and designed to furnish suitable protection to the business interests, to the farmers, and to the salaried and consuming classes of the country, shall be enacted.

Scope of National Banking System and Capital Invested

§2. According to the latest figures of the Comptroller of the Currency, the national banking system now includes 7,301 active institutions. Many have been formed only to fail or go out of business, but the system has steadily grown in the number of active banks until it has reached its present proportions.

In reviewing the condition of the system and in tracing its internal problems, it is essential to bear in mind the principal features relating to the distribution of capital among banks of different classes and among different states and localities throughout the country. The following table, compiled by the Comptroller of the Currency, furnishes the chief data with regard to this subject:

SUMMARY, BY STATES, GEOGRAPHICAL DIVISIONS, AND CLASSES, OF NATIONAL BANKS ORGANIZED FROM MARCH 14, 1900, TO OCTOBER 31, 1911, AND THE PAID IN CAPITAL STOCK OF ALL REPORTING NATIONAL BANKS ON SEPTEMBER 1, 1911.

States, etc.	Capital $25,000		Capital over $25,000 and less than $50,000		Capital $50,000 and over		Total organizations		National banks reporting Sept. 1, 1911	
	No.	Capital	No.	Capital	No.	Capital	No.	Capital	No.	Capital paid in
New England States										
Maine	4	$100,000	....	.....	7	$385,000	11	$485,000	70	$7,850,000.00
New Hampshire	4	100,000	1	$30,000	2	200,000	7	330,000	56	5,235,000.00
Vermont	5	125,000	....	.....	2	150,000	7	275,000	51	5,210,000.00
Massachusetts	1	25,000	....	.....	19	4,450,000	20	4,475,000	188	53,467,500.00
Rhode Island	....	.....	....	.....	1	500,000	1	500,000	22	6,775,250.00
Connecticut	4	100,000	....	.....	4	200,000	8	300,000	79	19,914,200.00
Total	18	450,000	1	30,000	35	5,885,000	54	6,365,000	466	98,451,950.00
Eastern States										
New York	97	2,425,000	9	287,500	97	17,970,000	203	20,682,500	462	172,143,369.50
New Jersey	51	1,275,000	7	210,000	41	3,510,000	99	4,995,000	196	21,987,000.00
Pennsylvania	219	5,475,500	24	807,000	223	24,080,000	466	30,362,000	832	118,319,390.00
Delaware	6	150,000	3	95,000	....	.....	9	245,000	28	2,373,985.00
Maryland	31	775,000	5	172,000	13	1,480,000	49	2,427,000	107	17,582,410.00
District of Columbia	....	.....	....	.....	4	1,250,000	4	1,250,000	11	6,102,000.00
Total	404	10,100,000	48	1,571,500	378	48,290,000	830	59,961,500	1,636	338,508,154.50

States, etc.	Capital $25,000		Capital over $25,000 and less than $50,000		Capital $50,000 and over		Total organizations		National banks reporting Sept. 1, 1911	
	No.	Capital	No.	Capital	No.	Capital	No.	Capital	No.	Capital paid in
Southern States										
Virginia	49	$1,225,000	10	$356,000	42	$4,565,000	101	$6,146,000	129	$16,668,500.00
West Virginia	35	875,000	11	395,000	39	3,265,000	85	4,535,000	107	9,337,000.00
North Carolina	21	525,000	4	130,000	28	2,710,000	53	3,365,000	74	8,385,000.00
South Carolina	12	300,000	....	.....	20	2,135,000	32	2,435,000	43	5,410,000.00
Georgia	25	625,000	20	675,000	49	4,650,000	94	5,950,000	114	13,944,500.00
Florida	7	175,000	4	125,000	25	4,125,000	36	4,425,000	45	5,966,530.00
Alabama	33	825,000	10	304,500	33	2,775,000	76	3,904,500	83	9,469,000.00
Mississippi	6	150,000	3	90,000	19	1,815,000	28	2,055,000	30	3,230,000.00
Louisiana	12	300,000	1	3 0,000	19	3,410,000	32	3,740,000	32	8,145,000.00
Texas	219	5,475,000	84	2,686,000	136	14,160,000	439	22,321,000	513	45,026,000.00
Arkansas	20	500,000	1	30,000	25	2,020,000	46	2,550,000	47	4,460,000.00
Kentucky	52	1,300,000	7	230,000	35	5,270,000	94	6,800,000	144	17,450,900.00
Tennessee	32	800,000	6	180,000	31	3,385,000	69	4,365,000	100	12,435,000.00
Total	523	13,075,000	161	5,231,500	501	54,285,000	1,185	72,591,500	1,461	159,927,430.00
Middle Western States										
Ohio	109	2,725,000	18	628,000	86	12,725,000	213	16,078,000	380	62,449,100.00
Indiana	90	2,250,000	15	483,000	67	9,150,000	172	11,883 000	260	27,428,000.00
Illinois	159	3,975,000	18	628,500	86	13,750,000	263	18,353,500	437	74,785,000.00
Michigan	14	350,000	4	130,000	26	4,790,000	44	5,270,000	100	14,710,000.00
Wisconsin	35	875,000	4	125,000	28	3,350.000	67	4,350,000	128	17,130,000.00
Minnesota	176	4,400,000	15	471,000	29	4,500,000	220	9,371,000	272	22,771,000.00
Iowa	111	2,775,000	19	630,000	60	3,645,000	190	7,050,000	329	21,520,000.00
Missouri	34	850,000	14	450,000	40	12,885,000	88	14,185,000	132	35,880.000,00
Total	728	18,200,000	107	3,545,500	422	64,795,000	1,257	86,540,500	2,038	276,673,100.00–
Western States										
North Dakota	121	3,025,000	7	215,000	9	500,000	137	3,740,000	148	5,285,000.00
South Dakota	68	1,700,000	3	90,000	13	700,000	84	2,490,000	102	4,205,000.00
Nebraska	103	2,575,000	20	715,000	38	3,335,000	161	6,625,000	246	16,185,100.00
Kansas	92	2,300,000	10	360,000	30	2,300.00,	132	4,960,000	210	12,012,500.00
Montana	23	575,000	4	130,000	16	1,340,000	43	2,045,000	58	4,940,000.00
Wyoming	11	275,000	....	.....	11	625,000	22	900,000	29	1,685,000.00
Colorado	51	1,275,000	11	361,000	38	3,310,000	100	4,946,000	128	10,820,000.00
New Mexico	24	600,000	4	125,000	10	575,000	38	1,300,000	41	2,020,000.00
Oklahoma	306	7,650,000	26	860,000	60	4,555,000	392	13,065,000	278	12,717,500.00
Total	799	19,975,000	85	2,856,000	225	17,240,000	1,109	40,071,000	1,240	69,880,100.00
Pacific States										
Washington	34	850,000	2	70,000	30	3,495,000	66	4,415,000	80	12,200,000.00
Oregon	32	800,000	2	56 ,000	23	1,595,000	57	2,451,000	78	8,216,000.00
California	90	2,250,000	5	160,000	97	24,562,800	192	26,972,800	204	52,507,650.00
Idaho	27	675,000	3	95,000	13	910,000	43	1,680,000	46	2,640,000.00
Utah	6	150,000	1	30,000	5	1,625,000	12	1,205,000	21	2,830,000.00
Nevada	3	75,000	....	.....	9	1,225,000	12	1,300,000	11	1,742,000.00
Arizona	4	100,000	1	30,000	5	250,000	10	380,000	13	1,055,000.00
Alaska	....	.....	....	.....	1	50,000	1	50,000	2	100,000.00
Total	196	4,900,000	14	441,000	183	33,112,800	393	38,453,800	455	81,290,650.00
Island Possessions										
Hawaii	2	50,000	....	.....	2	550,000	4	600,000	4	610,000.00
Porto Rico	....	.....	....	.....	1	100,000	1	100,000	1	100,000.00
Total	2	50,000	....	.....	3	650,000	5	700,000	5	710,000.00
Grand Total	2,670	66,750,000	416	13,675,500	1,747	224,257,800	4,833	304,683,300	7,301	1,025,441,384.50

Chartering of National Banks

§3. The most striking and characteristic feature of the national banking system is that access to it is freely granted. Under the national banking act, any five persons possessing the necessary capital may apply to the Comptroller of the Currency for a charter incorporating them to do business as a national bank. The charters thus granted run for twenty years and give to the institutions receiving them the usual corporate powers. Their capital is required to be paid up in money within six months after opening the doors for business, 30 per cent in specie being on hand in the vaults at the outset.

Theoretically, there is therefore no reason why any number of groups of men should not gain access to the national banking system as they desire. The only restriction comes from the policy of the Comptroller of the Currency. It is not mandatory upon the Comptroller that he grant national bank charters. In practice, therefore, he limits his extension of such charters to those cases in which he finds, after special examination, that there is a genuine demand for a bank, and that such an institution can be created without imperiling the business of any existing institution.

Under these conditions, and on the supposition that the men who apply for incorporation are solvent and are known business factors of proper standing in the community where they propose to organize the bank, the Comptroller of the Currency will usually grant them a charter. Of late, there has been a strenuous effort to discourage the granting of charters to promoters or persons whose object in effecting organization was not that of conducting the business of banking along sober and conservative lines. These restrictions, however, are purely a minimum. They are the necessary and fundamental requirements which must be enforced in order that the system may be kept free of injurious influences and maintained upon a basis of essential soundness and legitimacy.

Safeguards Against Banking Monopoly

The importance of the free banking principle thus provided for can hardly be over-estimated. It guarantees that the business of banking shall not, as in some countries, become a monopoly, and that it shall be freely open to all those who desire to enter it in good faith and with genuine capital. This idea of free access to the occupation is with justice regarded as fundamental in the American system of banking, and nothing could be more improbable than that any change will ever be made tending to limit or destroy this feature of it. The banks themselves properly desire that, so far as possible,

they shall be guaranteed against outside interference and shall be enabled to continue their business upon their own lines and without the domination of, or subservience to, larger institutions under the control of others.

Every proposal for a change in the existing system must, therefore, necessarily maintain these two ideas—freedom of access and freedom from control. This, however, does not necessarily mean that the banks are not to be limited and restrained at proper points, in order that they may be subjected to those methods of supervision which experience has shown to be necessary in all banking systems. They are, in fact, thus subject to oversight at the present time, for the law prescribes how their capital shall be paid and how their business shall be done.

The question of further legislation is not that of limiting or destroying freedom of access or competition, but is merely that of prescribing proper regulations designed to protect the banks themselves and the public against the development of evils at points requiring special safeguard. What are these points?

National Bank Note Issues, Their Restriction and Regulation

§4. A peculiar feature of the national banking system, growing out of the circumstances of its origin, is seen in the present method of issuing and securing bank notes. The bank note is theoretically different in no respect from any other form of banking credit, yet for reasons which will later be reviewed, it has been deemed specially worthy of restriction and limitation by legislative bodies.

In the national banking system, it was from the first provided that the total issue of notes by all the banks of the system should not exceed a specified sum, set at $300,000,000. It was further required that in no case should the total amount of notes obtained by any bank exceed the capital of that bank. Third, it was provided that the notes should be protected by national bonds which the banks were required to buy and deposit with the Treasurer of the United States, receiving back notes not to exceed 90 per cent of the face value of the bonds. Fourth, it was required that at least a specified percentage of its capital should be put by each bank into the form of bonds, such bonds to be used at its discretion as a basis for demanding issues of notes from the Treasury. Today all of these requirements and restrictions are in operation, except that which limits the total amount of notes issued by all banks.

Inelasticity of Note System

The limitation of outstanding issues to 90 per cent of the face value of the bonds has been displaced by one which permits the taking out of notes up to the par value of the bonds deposited, supposing these bonds to be selling at par or better. Under these conditions, it is evident that the total note issue cannot exceed the total amount of national bonds in existence, and in the case of any given bank, cannot exceed the amount of its capital. It is, moreover, obvious that the policy of the banks in taking out notes, above the minimum amount of bonds which they are required to buy in any event, would depend in no small degree upon the price of the bonds. In fact, the issues of bank notes actually taken out have varied and fluctuated largely in accordance with the price of bonds. Today the total note issue of all the banks is about $700,000,000. It is one of the most severe criticisms upon the national banking system at the present time that these notes displace gold, are expensive, fail to respond to the needs of the community, and are inelastic, often contracting when they are needed and expanding when they are not needed. The note system has been one of the points at which the National Bank Act has been most severely criticised, and in respect to which there has been the most strenuous demand for a rectification of existing conditions.

How Banks Are Classed Under the Reserve System

§5. More fundamentally significant to the national banking system, and equally as characteristic as the note issue plan, is the peculiar reserve system established under the act as modified in 1864. By this system three classes of banks are established. Three cities, New York, Chicago, and St. Louis, are designated as "central reserve cities," while some forty-seven others are designated as "reserve cities." All other banks are classed as "country banks." The reserve cities are Boston, Albany, Brooklyn, Philadelphia, Pittsburgh, Baltimore, Washington, Savannah, New Orleans, Dallas, Fort Worth, Galveston, Houston, San Antonio, Waco, Louisville, Cincinnati, Cleveland, Columbus, Indianapolis, Detroit, Milwaukee, Minneapolis, St. Paul, Cedar Rapids, Des Moines, Dubuque, Sioux City, Kansas City (Mo.), St. Joseph, Lincoln, Omaha, South Omaha, Kansas City (Kans.), Topeka, Wichita, Denver, Pueblo, Muskogee, Oklahoma City, Seattle, Spokane, Tacoma, Portland, Los Angeles, San Francisco, and Salt Lake City. The country banks are all those not situated in either of the groups of cities already referred to.

Under the terms of the National Banking Act, no bank is permitted to establish branches. Every bank is presumably an independent institution. According to the same law, country banks are required to hold a reserve equal to 15 per cent of their outstanding liabilities, and may re-deposit 9 per cent of it with reserve city banks. They thus retain in their own vaults, at the minimum, cash equal to only 6 per cent of their outstanding liabilities. The reserve city banks, which are required to hold a reserve equal to 25 per cent of their outstanding liabilities, may re-deposit one-half of this amount, or 12½ per cent, with banks in central reserve cities. They may thus do business with cash in the vaults equal to only 12½ per cent of their liabilities, provided they have on hand with banks in reserve cities a deposit credit equal to 12½ per cent more of their outstanding liabilities.

Regulations for the Independence of National Banks

As a matter of fact the banks have availed themselves of this reserve provision very extensively, and much of the present so-called reserves consists not of cash in their own vaults but of deposits in other banks in reserve cities. At a recent date of report to the Comptroller of the Currency, about 551 millions of dollars represented the total reserve held by country banks, while of this sum only 246 millions was actually in the possession of these banks in the form of lawful money. All the national banks of the country had reserves of 1,404 millions, of which only 862 millions was actual lawful money in hand.

§6. It is evident that as a result of this reserve system, very intimate relations between different classes of banks must exist. On the other hand, banks in the country and in reserve cities which have deposited their reserves with other banks are necessarily profoundly interested in the condition of these other institutions. To them they look for the resources which will enable them to fill up their own reserves in times of sudden demand for payment. To them they must look for accommodation through direct loans, or through the discounting of paper, or through some one of the various methods which are employed for granting relief to the smaller institutions when the stronger and larger banks are in position to afford such aid.

Relations of Banks to Each Other

Conversely, the city banks look with interest to the outside institutions as the source of deposits which they expect to use in times of financial ease and slack business in the country, for the

purpose of facilitating transactions in the cities and general financial operations. It is thus not true that our national banking system, though theoretically made up of more than 7,300 individual units, is actually composed of that number of independent organizations. On the contrary, the tie between the institutions, resulting from the present use of reserves, is an extremely close and intimate one. It is a tie which sometimes furthers the good of all who are connected by it, but perhaps as often is injurious or dangerous in its effects upon the welfare of the banks whose business is thus intertwined. Certain it is that in studying the development of the national banking system and in considering proposed changes with reference thereto, it is not possible to consider the different institutions as if they were independent. They must rather be regarded as already connected with one another, and changes must be spoken of simply as substituting a different kind of relationship for one which already exists.

Duties of the Comptroller of the Currency

§7. By the terms of the national bank act, the general oversight and control of the system is committed to an officer known as the Comptroller of the Currency, under the general jurisdiction of the Secretary of the Treasury. It is the Comptroller who has to do with the chartering of banks, regular examinations of them by bank examiners, the study of the returns made by the banks through these examiners, the writing of letters designed to call the attention of banks to cases in which they have failed to live up to the requirements of the system, and in general to take charge of the enforcement of the national banking act.

The Comptroller is an officer whose office is largely ministerial and who cannot be expected to use a large amount of personal discretion or judgment. The bank act indicates his duties, on the whole, quite precisely, and he can use a latitude of action only in those cases where there is doubt about the actual arrival of some event which has been provided for in the law. For example, it may be a question of judgment with him when to declare a bank insolvent and when to pursue the course mapped out in the act for the purpose of closing the institution. Upon the Comptroller depends much of the effective working of the banking system, since to him is committed the duty of seeing that the functions of the organization are adequately and properly fulfilled, and that there are no viola-

tions of charter. In proportion as he is able effectively to carry out this duty the system is likely to be effectively carried on.

Coöperation Among National Banks Is Practically Impossible

It is justly said that the banks have a much more vital interest in the proper conduct of their affairs than the Comptroller himself can have, and that they may be relied upon to accomplish the results that are sought. This might be true if banks were perfectly independent factors operating in accord with considerations of general well-being. But this is far from the reality. The larger banks have scanty means of knowing the details of one another's affairs and no means at all of enforcing their own ideas upon one another in any case. The smaller banks, while to an extent overseen and influenced by the larger, are not in touch with one another or able to judge of the movement of credit in the operations of the other institutions.

This condition means that there is strong need for some agency which will tend to unite the competing institutions in a certain degree and will in some measure afford a common bond between the banks. It is this which the Comptroller of the Currency is called upon to supply, and in so far as he is able under the law to furnish it he is an effective officer. The question whether he can effectively perform such a function is, however, largely dependent upon many conditions in the system itself. Of late years the great development of the class of small banks, the increasing difficulty of judging the value and quality of the paper held by the banks, and a variety of other factors have tended to diminish the efficiency of the Comptroller as a link between the widely scattered and separated banks of the system.

National Banks Only One Element in the Banking System

§8. The national banking system has come more and more within recent years to be merely one element in a great scheme of banking. As the most recent reports of the government show, the national banks number only about 7,300 out of an aggregate of perhaps 25,000 institutions, including in that total, state banks, private banks, and loan and trust companies. These other institutions are organized under the laws of the several states, and their position will call for special discussion at a later point.

It should be noted here merely that the national banking system stands in a peculiar position with respect to the banks of the states, for more than one reason. Not only is it the largest single set of institutions under one jurisdiction, but the terms of the national bank act, in limiting the kinds of business which the banks

may do, have marked them out in a peculiar sense as what are known as commercial banks. They are the institutions to which are committed the keeping of the funds of the country and the maintenance of a proper protection against outstanding liabilities. This is true for two reasons. The national banks, if they conform to the law, cannot invest their funds in anything except live, short-time commercial paper so that their resources are kept in a fluid condition. The national banks, moreover, have tended in an increasing degree to become the reserve holders of the country, the state banks and trust companies re-depositing their funds with the national banks, which are permitted to dispose of them as they see fit.

National Banks the Mainstay of the Banking System

In some states, requirements have been made as to the amount of reserve to be held by such state banks and trust companies that place them nearly or wholly on a par with the national banks. But in many states this is not true; and in most, the national institutions are subject to stricter regulation than the competing banks organized under state law. National banks are therefore subject to much more severe judgment than the state institutions, and they have thus far occupied a more responsible position. By reason of the act of Congress imposing on state bank notes a prohibitive tax, the power of note issue has practically been made a monopoly of the national banks, and thus they have again been differentiated from the institutions organized under state law. For these reasons the national banks are in reality the core of the credit and financial system of the country, and a change in their organization implies a change in the whole system of which they are a part.

Relation of the National Banks to the Government

§9. The relation of the national banks to the government is now clear, in so far as matters of organization and oversight are concerned. But in another sense, the national banks have a relation to the government that is possessed by no other class of institutions. They are not the holders of government resources, these being held, under the independent treasury system, in the Treasury and subtreasuries of the United States. But, since it frequently happens that the withdrawal of funds from circulation and their segregation in the Treasury is injurious to the community, the government is obliged to employ a banking mechanism for the purpose of again placing them in circulation. It must, moreover, at times make use of banking methods, in order that its operations may conform, even if only remotely, to the requirements of modern business. The

national banking system is the agency through which this connection between the government and the community is effected.

Government Uses National Banks Only

When government funds are to be deposited in banks, they are placed solely with national institutions. Even then they are required to be protected by the deposit of bonds of specified classes, to an equal amount, with the Treasury Department. When banking machinery has to be used for the purpose of making payments, it is the national institutions that are invariably utilized. Large quantities of funds are constantly held in national banks by the Treasurer of the United States and by government disbursing officers, while other officials, such as collectors of internal revenue, are permitted, upon their own authority, and at their own risk, to keep their funds in national banks and to receive payments in the form of checks and drafts upon other banks. Such arrangements are uniformly made with national banks. National bank notes are received by the government in many classes of payments and are regularly redeemed at the Treasury out of a fund provided for that purpose.

Method of Handling Public Funds Antiquated

It is thus clear that, despite the limitations of the independent treasury system, the national banks have an immediate and important relationship to the government and its funds. A change in the status of the national institutions must profoundly affect the methods of handling government funds; conversely, a change in the latter will have an important influence upon the national banks. It is probable, however, that the national institutions would feel the effect of such a change far less than would the Treasury itself, since the present method of dealing with public funds has proved antiquated, inadequate and ineffectual.

One of the most serious difficulties encountered in dealing with the banking problem today is found in the method of disposing of and caring for public moneys. It is evident that the day cannot long be deferred when the Treasury will have to abandon the present plan of withdrawing its funds from circulation and piling them up in the government vaults. The circumstances of modern business require that the government modernize its methods. The government is a huge business institution, but it has not learned to use banks in a business way.

§10. The defects of the national banking system are naturally found at those points where its characteristic features are

Defects of the National Banking System

most distinctly seen. In other particulars the system has not been different from any other. It is at the special points where it was formerly adjusted, with a view to meeting the particular requirements of the community, that it has tended to become obsolete or unsatisfactory, and it is consequently at these points that the system is necessarily calling for improvement and strengthening. No one desires to minimize the importance of the characteristic features of the national banking system. It is necessary to recognize the desirability of preserving its chief and essential merits. What is desired is to extend, elaborate and refine these merits, and to add such new methods of organization as will enable the banks to perform more perfectly, for their own service and that of the public, the functions entrusted to them at the time when the system was first set on foot.

National Banking System Gives No Protection Against Panics

The fundamental defect of the national banking system is to be sought in the fact that it is not in any proper sense a "system" of banking at all, but a series of banks artificially grouped. Because of the lack of coöperative or fundamental relationships between the institutions, it is not possible for them to exercise any general policy with reference to the control of reserves, the fixing of rates of discount, or the granting of loans. They can only act independently of one another, and the well-conducted institutions must, therefore, suffer from the mistakes of others whose conduct tends to arouse suspicion or alarm in the mind of the public. Because of this situation, it will be seen, the national banking system as at present conducted is in a sense a breeder of panics, while it fails entirely to grant any adequate relief from these commercial convulsions. It entirely fails to supply a note circulation, elastic, sound, adequate, and well adjusted to local necessities. It furnishes no general market for commercial paper, no matter how high the quality of such paper may be. It fails to meet the legitimate demands of the farmer, the depositor, the small merchant, and of other customer classes, just as it imposes upon the banks themselves severe hardship, due to their inability to protect themselves adequately against loss of confidence. In conjunction with the independent Treasury system, it furnishes only an inadequate and disturbing method of disposing of public funds, and is thereby an incalculable and uncertain factor in the money market. Its unavoidable lack of a discount policy prevents it from controlling the international flow of specie

as is done by the other banking systems of the world, or of supplying facilities for the transaction of foreign trade. The defects will be treated of at greater length in following chapters.

The Great Problem of the Day is Coöperation

From the foregoing brief discussion, it is seen that the aspects of the national banking system which are deemed most worthy of study, and which have furnished thus far most cause for dissatisfaction and for the feeling that improvements are feasible and desirable, grow out of the note issue function, the present reserve organization, the method of overseeing and inspecting the operations of the banks, and the conditions in the system which permit unduly independent action at times when such action may injure both those banks which resort to it and those who are indirectly affected by such action. *In general, it may be said that the great problem of the national banking system to-day is coöperation—coöperation among the banks themselves, coöperation between them and the government, and coöperation between them and the business public.*

Nearly all of the difficulties which have arisen in the history of the system have grown out of the lack of coöperative effort, implying as it does a failure to mass the full strength of the banks behind the business community in times of special demand for funds, whether these demands fell at particular seasons of the year or at periods of panic and difficulty.

Remedy for the Defects

§11. In the belief that the existing difficulties of the national banking system are those which follow from a lack of coöperation, it is designed herewith to discuss plans for a coöperative organization of a kind which would unite the banks into a single, coherent whole and would thereby not only place the strength of all at the service of any one, whenever aid could be legitimately demanded, but would economize the funds of the country and reduce the charge for banking accommodation, while equalizing such charges throughout the different portions of the United States. This plan is not intended to remove any of the essential features of the national banking system, or to increase the power of any element in it. It is intended as a labor-saving device for the common good of the community and for the perfecting of the system by adjusting its different parts to one another and enabling them to work harmoniously. In the following pages, the effort is made to explain the nature of this mechanism and to indicate what its effect would be upon certain aspects of the national banking system. Particular

effort has been made to explain how it would provide for the difficulties which now exist, and how far it could be depended upon to rectify evils in the system, which to-day constitute a serious menace to banking integrity and commercial soundness. In carrying out this design, a general survey of the proposed plan is first offered, and then its detailed operation is dealt with.

CHAPTER II

A COÖPERATIVE AGENCY

1. Defects of Banking System Diagnosed—2. Means of Coöperation—3. Why Coöperation Is Necessary—4. Protection to Deposits—5. Final Extinction of National Bank Notes—6. Control over Expansion—7. Uniform Rate of Discount—8. Discount Market for Acceptances—9. Protection from Wall Street—10. Political Pressure to Secure Government Deposits—11. Our International Position.

§1. The panics of 1893 and 1907 taught the weaknesses of the monetary and banking system of the United States with convincing thoroughness. It was demonstrated even more convincingly in 1907, that when the system is subjected to any strain beyond the ordinary it collapses. From the resultant injury no class of society is exempt. The experiences mentioned and the study that followed advanced the question to the point where remedies for known defects should be given legislative attention, discussion and action. We have, in fact, reached the point where we are ready to profit by our own experiences and disasters, and to take account of the results of carefully devised European methods.

Defects of Banking System Diagnosed

Although European conditions differ so much from ours that their institutions cannot be bodily transferred to our country, we have much to learn from them. Direct copying would be folly; we must take only that which aids us in a natural evolution out of our own past. The central bank of Europe is not suited to our conditions; it is contrary to the spirit of our institutions; and, in any event, it would be politically impossible. Nor do we need a bank of the type of the Second United States Bank (1816-1836), which excited the opposition of Andrew Jackson. We do not need a dominating, powerful Central Bank; what we need is not centralization, but coöperation—entered into by all our institutions of credit—to the end that we may avoid selfish isolation and create a federation in the interest of all the banks, small as well as great. We do not need an institution which discounts for the general pub-

No Central Bank

lic and competes for business; but we do need a coöperative union of all the banks in the common interest whenever danger appears. This coöperation, moreover, is more in the interest of the borrower than of the banker.

§2. Means of coöperation devised by a National Reserve Association should be aimed at a decentralization, rather than at a centralization, of credit—as opposed to a dependence of local banks upon centralized institutions, as now. Under the plan evolved by the National Monetary Commission all the banks in a locality would be grouped into a local Association, composed of not less than ten banks, whose combined capital and surplus should not be less than $5,000,000. Each separate Association would have local self-government; but yet, as we shall see, it would be a part of a coöperative plan. Three-fifths of the governing directors of the Association would be chosen on the basis of votes of banks without regard to size, each bank having one vote; and two-fifths of the directors would be chosen on the basis of votes in proportion to shares held in the National Reserve Association (i. e., in proportion to capital). It is also proposed, as a check against centralized control of local associations, that if a single shareholder had a forty per cent ownership in a chain of banks, the whole chain would have but one vote—and this rule would apply whether the shareholder were a bank, individual, corporation or association.

Means of Coöperation

Then, while locally self-governed, these Associations would be grouped in fifteen districts, into which the whole country would be divided. All the local Associations in a district would federate themselves—as in a republic—to form a branch of the National Reserve Association. The governing board of each district branch would consist of not less than twelve directors in addition to the manager; one-half the directors would be elected by the member banks, each bank having one vote; one-third would be elected by the member banks on the basis of the shares held in the National Reserve Association; the remaining one-sixth would be chosen by the directors already elected from the agricultural, commercial and industrial ranks.

The district branches would be federated in the National Reserve Association. The national directors would be chosen as follows: Each of the branches would elect two directors, one of whom must be neither a bank officer nor a bank director, but must rep-

resent the agricultural, commercial, industrial and other interests of his district; nine additional directors would be elected by voting representatives from the branches, each to cast a number of votes equal to the number of shares held in the National Reserve Association by the banks in his district; there would be seven ex officio members of the board—the governor and two deputy governors, together with the Secretary of the Treasury, the Secretary of Commerce and Labor, the Secretary of Agriculture and the Comptroller of the Currency. The executive officers would be appointed by the board of directors. Not more than three directors would be elected from any one district. The executive committee would be composed of nine members, including the three executive officers and the Comptroller of the Currency.

§3. Coöperation of our credit institutions, state and national, is desired, in order that the business public, producer and merchant, having legitimate demands for loans, should not be cut off from them by unnecessary and accidental conditions of panic. When collections are slow, or when an unexpected emergency arises, the borrower, holding staple goods or unquestioned collateral, ought not to be forced into bankruptcy by the inability to get the means of paying his maturing obligations. Moreover, seasonal demands arise which cause a stringency in the loan market and put an undue strain on our system of credit. The financing of the cotton or grain movement in the autumn has always been a cause of apprehension in the money market.

Why Coöperation Is Necessary

Demands of this character have given rise to a desire for a greater elasticity in our monetary and banking system. Such elasticity is thought of in connection with two different possibilities: (1) normal seasonal demands, such as the recurring needs of crop-moving; and (2) abnormal demands at the time of a financial panic. A common idea is that these demands can be met only by the issue of notes, or by some medium of exchange to be circulated in the hands of the public. This is the ground for some crude plans aiming at the issue of paper by the Government. In truth, while there is always a need for some change money in the pockets of everyone, some till and counter money in the hands of business houses and banks, and lawful money for settling clearing-house balances, the fundamental need is not solely for a medium of exchange (sufficiently provided by checks drawn on deposit accounts),

Elasticity of the Currency

but for loan power. If a borrower can get a loan, he will never have any difficulty in transferring his credit because of any lack of a medium of exchange.

Financing Crop Movement

In financing the movement of cotton and grain in the autumn, demands for cash from the country districts fall directly on the reserves of banks, because there are no means of providing temporary needs for cash except by drawing down reserves, and thus constricting the lending power of the banks, to the serious detriment of the borrower.

Likewise, but to a more acute degree of danger, in a time of panic the real need is not so much the issue of notes for circulation in the hands of the public (except to protect reserves), as for a loan to meet a maturing obligation. That is, the question is more truly one of the organization of credit than of the injection of additional money into the circulation.

For these reasons, it would be the purpose of a National Reserve Association, or whatever the coöperative agency may be called, to provide an elastic currency whenever it was needed by the public; to make this possible without drawing down bank reserves; to give credits based on cotton, grain and the like, without expensive shipments of cash to and fro; and, finally, in time of panic, to provide the possibility of getting loans—which is more important than an increase of the circulation.

Rediscounts by Branches of the Reserve Association

These ends would be accomplished by the individual bank—national bank, state bank, or trust company receiving deposits—presenting picked assets to be rediscounted by the branch offices of the National Reserve Association. This opportunity would be extended equitably to every subscribing bank, big or little, without discrimination. The credit given the borrowing bank could be used as a part of its legal reserve, which would thus enable it to meet the demands of its customers, or it could get National Reserve Association notes to the same amount, and place these in its reserves. This would be merely an evolution out of our experience with Clearing-House Associations, and an improvement upon, and legalization of, the idea of Clearing-House Loan Certificates well known to banking history.

The individual banks would be able to obtain such rediscounts in four different ways:

(1) Any bank might, without any guaranty, have twenty-eight-day paper discounted upon its own endorsement.

(2) If the paper should run for more than twenty-eight days, but not longer than four months, it would have to be guaranteed by the local Association.

(3) In times of stress, the subscribing bank might borrow under careful restrictions directly on its own obligation, if the loan were protected by satisfactory collateral and guaranteed by the local Association.

How Rediscount System Would Work

(4) Time bills of exchange, running not over ninety days and accepted by houses or banks in good standing, might be purchased by the National Reserve Association from subscribing banks to a limited amount.

If any banks were at first not disposed to take any interest in the plan, thinking they could earn more on their capital than by subscribing to a National Reserve Association, they would find themselves "outside of the breastworks" when a stringency came, and would learn the advantage of membership by stern experience.

§4. The safety to depositors is also to be kept in mind. If, for instance, a country national bank had $100,000 deposits, it would be obliged under the present law to keep $6,000 on hand in lawful money. In times of doubt, depositors would measure the ability of the bank to meet a run by this amount of cash; and in a short time this reserve would be easily exhausted and the bank obliged to close its doors. The depositors owning the claims to the remaining $94,000 would then be forced to await the process of liquidation before they could get cash for their deposits. In case, however, the bank were a member of a National Reserve Association, the public would know that the ability of the bank to pay off depositors would not depend upon the amount of actual cash held at any moment, but upon the amount and character of its assets which could be used as a basis of discount at the National Reserve Association. That is, an institution like a National Reserve Association would most effectually enable a bank with sound assets to convert them into cash, and serve as the best method yet known of guaranteeing cash payments to the individual depositor.

Protection to Deposits

§5. The inelasticity of our national bank circulation, or of any notes based on the security of bonds, has long been admitted. It is not desirable, however, to make any sudden or drastic changes which might cause possible disturbance or losses. There has been

more or less antagonism to the issue of notes by banks, on the ground that the profit of issuing notes should go to the United States by the issue of its own notes. In our own experience, however, the issue of greenbacks has, in fact, been costly to the Treasury because of the expense of maintaining reserves. But since the profit to a bank in discounting can be obtained as truly when it grants the borrower a demand deposit account as when it issues to him its demand notes, the note-issues cannot be regarded as a special source of profit. This explains why state banks, issuing no notes, can accumulate large profits as well as national banks. But if there is any value in the idea of withdrawing the notes of national banks, it appears in the plan of the National Reserve Association, which proposes the eventual extinction of national bank notes and their replacement by notes of an office which would be closely under the supervision of the Treasury. Thus all the dangers and disadvantages of Government notes would be escaped, while all surplus profits from discounts, above four or five per cent to shareholders, would go to the Association's surplus or to the United States Treasury. In this way, the people would get whatever profits arose from the issue of notes by the National Reserve Association; and the national bank notes would ultimately disappear.

Final Extinction of National Bank Notes

The bonds now owned by the banks for the security of national bank circulation would be taken over by the National Reserve Association, which would assume the redemption of the national bank notes. These bonds are largely two per cents, which have a fictitious value due to the circulation privilege. Therefore, if the circulation privilege were withdrawn, to prevent injustice the Treasury should be empowered to refund them at a rate (say three per cent) based on investment conditions and the credit of the Treasury. If the losses had to be borne by the banks, they would properly decline to enter the coöperative union.

The banks, state and national, would be required to provide the capital of the National Reserve Association. Banks would not get more than four or five per cent on their stock in the National Reserve Association, and it should be provided that earnings beyond that dividend should partly go to surplus, or to a contingent fund, but mainly to the Treasury of the United States. Thus a National Reserve Association would by no means be a profit-making institution to its shareholders, and there would be no inducement to the management to over-expand for the sake of larger earnings.

Not a Profit-making Institution

§6. Elasticity of the currency properly implies, not only expansion under legitimate need, but contraction when the need has passed. The expansion of credit, however, may take place by an undue expansion of loans, which shows itself in an enlargement of the deposit accounts credited to borrowing banks—in case notes are not needed by them. The obvious protection from over-expansion of loans, in normal times, and the avoidance of support to speculation, would be found in requiring a National Reserve Association to keep a large gold and cash reserve for its demand liabilities, both notes and deposits. Should the reserve fall below a legally-fixed limit, the deficiency should be progressively taxed, so that for the protection of its diminishing reserves the National Reserve Association would raise the discount rate, thus making the borrowing banks pay the tax imposed. This would stop any loan demand for speculative purposes. Thus the National Reserve Association notes would be quickly available in time of stress, but could not profitably be kept out when not needed. They would be redeemable on demand, in gold, or lawful money, and the total demand liabilities would be protected by a substratum of bonds (as in the case of the note issues of the Bank of England), a stratum of lawful money, a stratum of gold, and a stratum of short-time commercial paper (as in the case of the Reichsbank of Germany). The relative amounts of the stratum of short-time paper and the stratum of cash would be controlled by the tax on loans. There can be no over-expansion where there is immediate redemption in cash of all demand liabilities.

Control Over Expansion

The fall of reserves is always a signal of danger under the present system. Indeed, when reserves fall to the legal limit (twenty-five per cent in central reserve cities), we have no reserves in the proper sense of the term. The surplus reserve is the only one which can really be made use of. Consequently, our rigid legal percentage of reserves causes a sudden stoppage of loans, and often failure and ruin to needy borrowers. Hence, at present, all attention is centered on the quantity of a bank's cash reserves. If trouble threatens, each separate bank clutches at reserve money in selfish isolation. Herein is our great danger. At such a time, the large banking institutions have exceptional power to aid, or refuse help to, smaller institutions. Under present conditions, when small banks must go for assistance to the large banks, we have a system of practical centralization, based on special favors to desirable correspondents.

Grasping for Reserves

Under any plan for a coöperative banking agency, the reserves should be so mobilized that aid can be given at the point of danger in amounts sufficient to prevent failures. The present scattering of reserves and the grasping of legal money would be stopped, because any bank having good assets arising from loans could get rediscounts at the National Reserve Association and thereby replenish its reserves. As things are now, because of scattered reserves, a local bank, even though having good paper, would not be sure of assistance in time of need from its correspondent in a large central city. It would be otherwise with a National Reserve Association. Of course, no bank could secure rediscounts on unsatisfactory paper; but in case of stress and strain the banks, large or small, having good discountable paper would know of a certainty that the National Reserve Association would be in a position to make a loan. This kind of coöperation means a decentralization of banking credit. The safety of a bank would be judged by the character of its assets rather than, as now, by the amount of its cash reserves. The advantage of combining reserves has been likened to having a large reservoir of water, available as a protection against fire by any one householder, as compared with a system in which each would have only its single pail of water. If water reserves are scattered, then when a fire comes, each would try to steal the other's water.

Economy of Reserves

In order to stop this unnecessary grasping for legal reserve money—to hold the reserves (as in a reservoir) for the common good in a place where they can be directed as a whole against threatened danger—it is proposed that the banks should keep the legal reserves now required to be kept in their own vaults (6 per cent for country banks, 12½ per cent for reserve city banks, and 25 per cent for central reserve city banks), in the National Reserve Association vaults. Today we have a quantity of gold in this country so large as to meet all possible dangers, but it is so scattered, or so disposed, as to be practically useless in a serious emergency. In such a situation, the United States Treasury is subject to private demands for deposits of government money. This should not be. By creating a proper efficiency and economy of reserves and by protecting them with the note-issuing power of a National Reserve Association, thus applying business sense to public finance, the exchanges of the country could be carried on at a less cost, and vital dangers to our credit could be avoided or lessened.

The Country's Supply of Gold Is Useless in Emergency

§7. In Europe, the ability to raise or lower the rate of discount affords an effective means of controlling undue expansion of loans, and yet to give legitimate aid in time of pressure. In this country, the requirement of a fixed percentage of reserves is often a source of danger, for it is unlawful to increase loans just when reserves are running down below the legal limit and when loans are imperatively needed. The long and successful experience of Europe teaches us that a sliding scale of rates for loans, falling as reserves fill up and rising as reserves decline, is the best device to prevent over-expansion of credit, and yet to afford aid in time of danger. To accomplish this end, there should be some means by which the National Reserve Association could from time to time indicate to its borrowers—the banks—the current rate of discount which would rise as reserves fell, and *vice versa*. Obviously, a National Reserve Association must treat all borrowers, big and little, alike; and hence the rate of discount must be uniform to all applicants. This, of course, is primarily in the interest of the borrowing public. The banks in some districts where capital is scarce and rates high would not enjoy this provision; and in old districts where rates are now very low, it might possibly raise them a little—equalizing rates more or less throughout the country, much like the effect of branch banking in Canada. On the other hand, it is to be remembered that the dealings of a National Reserve Association would be only with banks, and not with the public. Hence, as in such central money markets as London, Paris and Berlin, there would be the reserve agency's rate of discount; and alongside that an unofficial rate (on the street) of individual banks with their customers depending, as now, upon the conditions of demand and supply of loanable funds and upon the quality of the paper offered. Thus, in practice, there would remain a desirable elasticity of rates, together with a governing force regulating the general level.

Uniform Rate of Discount

§8. In this country, promissory notes make up the bulk of our banking paper, and their security varies as widely as does the standing of the borrowers. In Europe, on the contrary, the bill of exchange is the usual form of paper.

Discount Market for Acceptances

An American merchant, who has a bill for goods he has purchased, borrows money on his own promissory note at the bank, pays the bill with it and gets the cash discount. His obligation

is thus transferred from the concern he bought of to the bank where he made the loan. Ordinarily, the bank does not know for what purpose he borrowed the money, and he may or may not use the proceeds of the loan to pay his bill for merchandise. A deposit credit is given him at the bank and he draws checks against it.

In Europe the seller of the merchandise draws a time bill on the buyer; or, what is of especial interest in the financing of foreign trade, the buyer (importer) enters into an arrangement with his bank by which the seller (exporter) draws directly on the bank, and the bank accepts the bill. (See Chapter VI.) The bank has its protection from the buyer of the merchandise, the seller is insured by the credit of the bank and the accepted bill goes on the market. The paper so created explains on its face the nature of the transaction out of which it grew.

Difference Between American and European Methods

Such acceptances can be bought and sold in any discount market where the bank has standing. They form an asset immediately convertible into cash, being even superior to a government bond. In the United States, the right to accept a time bill of exchange is now forbidden by the courts to national banks. It is proposed that acceptances of time bills of exchange should be made possible to subscribing banks. Should acceptances of this kind be allowed to all subscribing banks, however, without restraint, there might be dangerous over-expansion of credit. Therefore, the use of acceptances should be hedged in by such restrictions as will prevent all possibilities of abuse and over-expansion.

Moreover, it must be kept in mind that in the United States the development of credit to the manufacturer, jobber and retailer has been so carefully worked out that those in good standing can borrow on one-name promissory notes, enabling them to pay cash for materials and goods, and thus gaining the highest trade discounts. This is one reason why so little strictly commercial paper exists in this country, as compared with bills of exchange created on the sale of goods in Europe. This fabric of credit in the United States—probably more advanced here than in Europe—should be carefully protected, and in no case should the system of acceptances be introduced at the expense of stability and safety to our existing structure of credit.

§9. The right of subscribing banks to accept time bills of exchange and the creation of a discount market would help to free our money market from the influences that aim to use bank funds

for speculation in Wall Street. To accomplish this end still further, the election of directors of the allied associations and of the final governing body of the reserve agency should be so contrived that any group of special interests, financial or political, could not control its policy, or use the organization for their selfish advantage. The local self-government of each Association, and the federation of the Associations, should be so built up from independent units that domination by a few, no matter how powerful, would be humanly impossible. The existence of directors drawn from trade, industry and agriculture, would bring to bear the vigilance of the borrowing, as distinct from the lending, public.

Protection from Wall Street

Moreover, the plan of a National Reserve Association, following the long-established policy of European banking, aims to encourage commercial loans arising from an exchange of goods, and to discourage loans arising from stock exchange transactions. In the Monetary Commission's plan rediscounts (not guaranteed) for subscribing banks by the National Reserve Association are especially forbidden, if known to be used for carrying stocks, bonds, or other investment securities. Only in case of great stress, and only with the approval of the Executive Committee of the National Reserve Association and the Secretary of the Treasury, would discounts be allowed directly to a subscribing bank, when protected by securities—and even then, only when endorsed by the local Association. This rule follows European experience, by which a higher rate of discount is usually charged for loans based on stock exchange securities than for bills arising from the purchase and sale of staple goods.

The One Aim Is the Protection of Legitimate Business

The one end to be sought is the protection of the commercial interests of the country. Under the present system of recognizing speculative securities as equal or superior to commercial paper as the basis for bank loans, legitimate business and stock speculation are too closely connected. The one suffers when the other is unduly extended. There have been notable instances in recent years of the inability of the country to finance a speculative and a business boom at the same time. And yet so closely are the two connected under our centralizing system that the collapse or partial collapse of either reacts on the other. Wherever the trouble starts, the result is the same and business inevitably suffers. Legitimate business is in need of protection and is to be divorced from its relation to speculation.

Likewise, a National Reserve Association, acting as the coöperative organization of all the banks in the country, should be able to import gold for the protection of the reserves, for the common good, instead of leaving this operation, as now, to the leadership of large private institutions in close connection with the securities market. Such action would be public, and every subscribing bank, large or small, would be a participant in the resulting stability of the combined reserves.

Also, when a National Reserve Association became the custodian of the funds of the Treasury, it would end all possible pressure upon the Treasury to come to the aid of the money market in stringencies caused by the movement of the crops, or an acute financial crisis. If Wall Street operators needed assistance, they would be obliged to get it through their own banks, which would have to assume all the responsibility, knowing they could get little or no help from rediscounts with the National Reserve Association.

§10. In times past, the Treasury of the United States with a surplus has caused unnecessary difficulties in the market, because sums due the Treasury were drawn from the lawful reserves of the banks, without any regard to the conditions of business or the needs of borrowers. This mechanical operation has long been seen to be obsolete; and the obvious remedy has been the deposit of government funds in the national banks designated as depositories. But this has resulted in political pressure to obtain government deposits for this or that district. Moreover, the Treasury has necessarily been called on, in times of panic, to help privately-owned national banks by deposits which filled up their reserves and rescued the borrowers from ruin. All these methods are undesirable, clumsy and contrary to the seasoned experience of older countries.

Political Pressure to Secure Government Deposits

If a National Reserve Association were established, the force of a panic and the pressure for lawful money reserves would be met by the combined reserves of a coöperative, decentralized institution. Should the funds of the United States Treasury also be kept with a National Reserve Association, there would be no more unexpected, jerky calls from the Treasury for cash; the payments by and to the Treasury would be adjusted by credits on the books of the reserve association in a businesslike way, after the fashion of any other large commercial operation, without the present ex-

The Fiscal Agent of the Treasury

pensive and disturbing movement of cash. No other country of importance maintains such an antiquated system as ours, which dates back to 1846, when government payments were small and business conditions were very different from what they are now.

Not only would our system of credit be thus relieved from unnecessary shocks coming from the Treasury, but the power of the Treasury to interfere with the money market would cease, and with it all political connection with our banking situation. Moreover, the expense of handling the funds of the United States Treasury would be transferred to the National Reserve Association, while its operations would come directly under the eye of Treasury officials. For all these reasons, the proposed reserve agency should be made the fiscal agent of the Treasury.

§11. Great as is our wealth as a nation (about $125,000,000,000), and vast as is our foreign trade (some $3,500,000,000 a year), our banking and credit system is not what it ought to be in view of our real merits as a trading nation. To gain prestige due us in international finance, much depends on our organization of credit. Certain steps in the right direction are obvious:

Our International Position

(1) Foreign capital will flow into our money markets if we are wise enough to create an international discount market through the use of acceptances. This kind of paper would be useful in creating credits in Europe, on which we could draw for gold in the day of need. In other words, acceptances would open to us the door to the abundant capital of older nations, instead of our being obliged to make intense demands at certain seasons upon our own capital at home.

(2) Our ill-regulated credit system, with its spasmodic and violent reactions, causes us to make special demands on Europe for gold which are regarded as unreasonable and unnecessary. We are looked upon as a nuisance and as a creator of financial disturbance. Our detached and unorganized mass of banks prevents us from acting unitedly in the common interest with foreign countries. Therefore, a coöperative institution, acting as the representative of all our banks—instead of private institutions acting for their own correspondents, and for only a small number of the banks—

should be established, which would have the standing, capital and power to borrow gold abroad upon the deposit of government bonds, to deal in foreign exchange, and, in general, to protect our banking and credit position in international trade.

Lack of Banking Facilities Handicaps Foreign Trade

(3) Our trade, especially in the East and in South America, is handicapped by the absence of American banking facilities. This has been long recognized by the merchants in our export trade. Other countries, like Great Britain, Germany, and even Italy, Belgium and France, have been quite active in this important matter. It should, therefore, be permitted to a National Reserve Association to establish under its supervision branches in foreign countries which might worthily represent the wealth and banking power of the United States and assist our own merchants who wish to sell their goods in other lands.

CHAPTER III

PRESENT RESERVE REQUIREMENTS

1. Rigidity of the System—2. Our Reserve System Makes Credit Inelastic—3. Foreign Practice in Contrast With Ours—4. Stringencies Bring Out Fundamental Defects—5. Redepositing Reserves Encourages Speculation—6. Our Reserve System Implies High Cost of Loans—7. Country Paper at a Disadvantage—8. Lack of Discount Market Limits Loans—9. Remedy.

§1. The outline of the present reserve requirements under the national banking system has already been sketched. It undoubtedly constitutes the foremost problem in the present system of banking, inasmuch as the control of his reserves, and the general condition of the reserves of the country, as a whole, is always the chief anxiety of the careful and far-seeing banker. We are aware that the national banking system fails to perform its functions adequately at the present time. In seeking for a remedy which shall not only insure a greater soundness than at present, but shall further supply the desired elements of economy and flexibility, attention is therefore given, first of all, to the question of reserves under our national system and the methods by which they may be better dealt with.

Reserves Present a Fundamental Question

What chiefly strikes the student of reserve conditions under the national system is the fact that the banks of the country are required to maintain a rigid amount of reserve money. In the country banks are required to hold reserves of 15 per cent of their outstanding liabilities. Reserve city and central reserve city banks must hold 25 per cent; the country banks are required to keep 6 out of their 15, and the reserve city banks 12½ out of their 25 per cent of reserve in their own vaults; but the country banks may deposit 9 per cent with reserve agents, and reserve city banks 12½ per cent in central reserve banks. As the banks of the country are called upon to maintain their reserves in this rigid way it is obvious that they must stop lending whenever the line of safety drawn by the law is reached. They have then in practice as a flexible resource only what are known as "surplus reserves"—the amount of cash re-

sources held over and above the sum specified by the law as their minimum or "legal" reserve. Just how much margin this actually leaves the banks in the several parts of the country may be understood from a recent analysis (1910-1911) of reports to the Comptroller of the Currency in which are shown the various reserves and surplus reserves. This analysis is as follows:

Excess Reserves Held by National Banks

Date of Call	Reserve Held	Per Cent Reserve Held	Amount of Excess Reserve
Reserve City Banks			
Central Reserve Cities			
Nov. 10	$353,883,747	25.44	$ 6,102,585
Jan. 7	367,733,656	25.83	11,917,926
Mar. 7	441,079,390	26.77	29,222,530
June 7	459,639,243	27.37	39,727,578
Sept. 1	426,547,745	26.00	16,366,078
Other Reserve Cities			
Nov. 10	432,633,340	25.36	6,115,050
Jan. 7	443,601,978	25.81	13,940,367
Mar. 7	464,220,842	25.49	8,996,195
June 7	481,364,283	26.03	18,982,597
Sept. 1	471,051,269	25.46	8,510,136
Total Reserve Cities			
Nov. 10	786,517,087	25.39	12,217,635
Jan. 7	811,335,635	25.82	25,858,294
Mar. 7	905,300,232	26.10	38,218,725
June 7	941,003,526	26.66	58,710,175
Sept. 1	897,599,614	25.71	24,876,214
Country Banks			
New England States			
Nov. 10	50,908,260	16.63	4,995,796
Jan. 7	50,365,635	16.25	3,884,202
Mar. 7	50,429,520	16.58	4,807,444
June 7	51,483,341	16.66	5,132,821
Sept. 1	50,386,037	16.20	3,728,725
Eastern States			
Nov. 10	152,949,762	16.49	13,830,947
Jan. 7	151,327,893	16.31	12,182,812
Mar. 7	153,838,553	16.36	12,793,149
June 7	159,213,845	16.58	15,129,165
Sept. 1	158,454,286	16.13	11,105,320
Southern States			
Nov. 10	91,441,126	17.61	13,542,507
Jan. 7	96,292,240	17.67	14,559,848
Mar. 7	93,799,050	17.45	13,176,534
June 7	92,110,198	17.63	13,755,559
Sept. 1	87,737,299	17.30	11,655,885
Middle Western States			
Nov. 10	146,005,871	16.97	16,916,961
Jan. 7	145,986,538	16.93	16,666,927
Mar. 7	145,607,478	16.49	13,140,752
June 7	148,174,025	16.85	16,234,313
Sept. 1	148,781,250	16.47	13,243,280
Western States			
Nov. 10	53,024,253	17.34	7,146,742
Jan. 7	52,157,682	17.55	7,571,676
Mar. 7	51,653,814	17.08	6,295,378
June 7	52,089,389	17.50	7,438,048
Sept. 1	51,121,223	17.15	6,396,365
Pacific States			
Nov. 10	33,267,577	17.72	5,101,222
Jan. 7	33,231,881	18.21	5,858,785
Mar. 7	33,154,664	18.31	5,995,525
June 7	33,647,376	17.82	5,317,351
Sept. 1	33,408,858	17.62	4,973,021

It is thus clear that the rigidity of reserve requirements on the part of the banks subjects them to the necessity of promptly ceasing to loan when their reserve line is approached, or else of building up their reserves in some other way. They can do the latter only by applying to other banks for accommodation; that is, by selling to the other banks certain of their assets, or borrowing from them some of the latter's funds. Of course, this process is resorted to in a degree by all banks, but, for reasons which will later be examined more in detail, present conditions do not admit of its being carried very far when the need is most urgent.

§2. The chief reason why larger banks are not able to assist smaller institutions to a greater extent than they now do, and why smaller banks need this larger accommodation, is the attempt to maintain many small reserves at different points throughout the country. Since every bank recognizes that it must keep up its reserve funds to the figure indicated by law, unless it is willing to subject itself to the danger of being closed by the Comptroller, it feels the necessity of drawing upon other banks for funds whenever it finds the required minimum in danger of being trespassed upon. No bank, therefore, which holds the deposits of other banks, can ever feel sure that it may not be hastily called upon to supply them with actual cash; and since every bank has outstanding liabilities several times greater than the amount of its reserves, a sudden demand for cash from all parts of the country results in depleting the funds in reserve cities and central reserve cities to a point where they are in danger of falling below the legal requirement. The larger banks of the country thus live in a condition of doubt whether they may not suddenly be required to part with the whole of their surplus reserves and thereby to be deprived of the power to make further loans to their customers.

Many Small Reserves

Fear of Sudden Demands

Whenever there is a sudden call for large loans in the interior, the necessities of the public cannot be satisfied by the simple process of testing the paper offered to the banks and then reselling it to the larger institutions which hold the reserves of the country; nor can the whole transaction be settled on a basis of bank credit. Under our system, actual currency must move. The rigid reserve system requires that a given proportion of liabilities be maintained in the vaults. Moreover, with notes practically in-

elastic, many loans in country districts must take the form of actual currency or money. This means a very large movement of currency from bank to bank at certain seasons of the year. A like movement takes place at those periods when the business of a particular community is rising to a higher level and when there is a call for steadily increasing volumes of bank loans. Under such conditions, the scattering of reserves is marked. Cash is accumulated for local use when it ought not to be drawn off from other portions of the country, but left at their service.

Why Currency Must Move

Both periodically and regularly, therefore, there is an ebbing and flowing of currency which keeps a large quantity of circulating medium in transit and demands the services of another large quantity as a support for bank loans. This greatly reduces the volume of outstanding bank credits which can be maintained upon a given quantity of reserve money. It is probable that no country in the world has so small a volume of bank credits outstanding as the United States, in proportion to the amount of money retained in the country. Thus is created a condition which implies the holding in idleness of large quantities of coin that might otherwise be dispensed with. It shows why the great "per capita" circulation of the United States is not beneficial, but, on the contrary, is an expensive luxury which the community cannot afford to maintain. This is quite in opposition to the usual view of the relation between money and bank credit in the community, but a reference to foreign experience corroborates it.

Unnecessary Shipment of Currency

The national banking system has been able to expand its deposit-credits satisfactorily in response to the calls of the commercial community for loans, whenever there was no doubt about its general solvency and ability to redeem. This has been due to the fact that the granting of the deposit-credits was not hampered and crippled by anything corresponding to the bond-deposit-requirement which has so limited the elasticity and flexibility of the notes. But times arrive in every commercial country when there is doubt concerning the value of goods and paper. On such occasions it is the function of good banking to discriminate between the good and the bad paper, and to continue unhesitatingly to advance capital upon that which is of unquestionable soundness. When that is done, the effect of lack of confidence, or stringency, is simply to sift good assets from bad. The men who own the sound commercial paper do not seriously suffer.

Elasticity of Credit Under Good Banking

If, however, the system is such that banks are unable to continue their advances, no matter whether the paper offered to them is good or bad, because they fear for their own existence, it cannot be regarded as being a sound system, or as having met the commercial requirements of the community. That is, in truth, the unfortunate situation under the present national banking system, owing to its peculiar use of reserves. With reserves widely scattered and with no definite assurance on the part of the banks that they can dispose of commercial paper, no matter how sound such paper may be, every institution must necessarily protect its own interests from a selfish standpoint by refusing to continue accommodations to the public whenever it appears likely to be subjected to serious strain. This strain usually takes effect in a drawing down of reserves.

Our Reserve System Makes Credit Inelastic

§3. How the national banking system fails to perform its part during such a period of special strain can be clearly illustrated by comparing the accommodation extended to the public by the national banks with that extended to the public by some of the principal foreign banks in the same periods. A contrast of this kind can be instituted to good advantage between the banks of the national system and the large central banks of France, England, and Germany. In the following tables are represented the loans and discounts, reserves, and the individual deposits of the banks in the system for the five dates during 1892 and 1893, upon which regular reports were made to the Comptroller, while the first report in 1894 is also added. Reviewing these figures, it is seen that the high-water mark of loans and discounts and, at the same time, of deposits was reached during the latter part of 1892. When a stringency came on, both fell off, and a low point was reached in 1893, whereupon recovery started. The five dates for 1907 and the first date in 1908 have likewise been compiled. During 1907 there was an increase in loans and discounts and deposits up to August, when stringency set in and a serious decline was brought about, this decline continuing into the following year.

Loans Diminish and Reserves Increase in This Country

The figures given for reserves or stocks of money in Europe show that there was a shrinkage of these stocks in the hands of the foreign banks practically at the same time that they were enlarging their accommodations, while the specie stocks of the

Quite the Opposite in Europe

national banks enlarged as they curtailed their accommodations. The foreign banks helped their customers and let go their cash for that purpose. Our banks refused aid to their customers and insisted upon accumulating larger stocks of money than they would have sought, even in normal times.

NATIONAL BANKING SYSTEM
(000,000 omitted.)

	Loans and Discounts	Individual Deposits	Reserves
1892			
Mar. 1	$2,058,	$1,702,	$353,
May 17	2,108,	1,743,	373,
July 12	2,127,	1,753,	366,
Sept. 30	2,171,	1,765,	327,
Dec. 9	2,166,	1,764,	318,
1893			
Mar. 6	2,159,	1,751,	313,
May 4	2,161,	1,749,	322,
July 12	2,020,	1,556,	289,
Oct. 3	1,843,	1,451,	346,
Dec. 19	1,871,	1,539,	414,
1894			
Feb. 28	1,872,	1,586,	434,
1907			
Jan. 26	4,505,	4,115,	695,
Mar. 22	4,572,	4,269,	656,
May 20	4,664,	4,322,	691,
Aug. 22	4,709,	4,319,	701,
Dec. 3	4,662,	4,176,	660,
1908			
Feb. 14	4,452,	4,105,	788,

In Panic Times Banks Protected Themselves

The next table exhibits still further the distribution of loans and discounts, individual deposits, and reserves among the central reserve cities, other reserve cities, and country banks of the National Banks in the United States, during the critical periods of the panics of 1893 and 1907. The figures in this table show the difference in attitude towards their customers which was adopted by the banks in the United States as compared with those in Europe; and inferences may also be drawn as to the attitude of the large city banks as compared with that of the country banks. The reader should note the change in the loans, and also in the deposit item, which is often the result of loans. If the loans fell off, it would show that the banks were liquidating their loans to the public, in order to reduce their immediate liabilities; on the other hand, an addition to the reserves would show that the banks were protecting themselves. If the reserves were increased at the same time that loans to the public fell off, it would show that under our system the banks were driven to the policy of refusing loans just at the time when they were most needed by the public.

LOANS AND DISCOUNTS

(000,000 omitted)

	Central Res. Cities	Other Res. Cities	Country Banks
Dec. 9, 1892	$ 452	$ 534	$1,175
Mar. 6, 1893	356	522	1,267
May 4, 1893	436	527	1,193
July 12, 1893	571	493	1,105
Oct. 3, 1893	377	442	970
Dec. 19, 1893	404	471	974
Feb. 28, 1894	415	472	967
Jan. 26, 1907	1,054	1,196	2,212
Mar. 22, 1907	1,039	1,224	2,272
May 20, 1907	1,097	1,231	2,302
Aug. 22, 1907	1,061	1,242	2,374
Dec. 3, 1907	1,110	1,182	2,292
Feb. 14, 1908	1,070	1,153	2,198
May 14, 1908	1,139	1,159	2,229
July 15, 1908	1,195	1,175	2,244
Sept. 23, 1908	1,242	1,231	2,275

INDIVIDUAL DEPOSITS

	Central Res. Cities	Other Res. Cities	Country Banks
Dec. 9, 1892	$ 380	$ 423	$ 956
Mar. 6, 1893	374	404	970
May 4, 1893	382	409	953
July 12, 1893	328	371	779
Oct. 3, 1893	330	352	764
Dec. 19, 1893	362	390	782
Feb. 28, 1894	294	400	816
Jan. 26, 1907	666	982	2,466
Mar. 22, 1907	770	996	2,502
May 20, 1907	794	1,020	2,508
Aug. 22, 1907	739	1,012	2,566
Dec. 3, 1907	783	937	2,456
Feb. 14, 1908	761	932	2,411
May 14, 1908	886	1,004	2,421
July 15, 1908	889	1,033	2,451
Sept. 23, 1908	961	1,067	2,518

RESERVE HELD

	Central Reserve Cities		Other Reserve Cities		Country Banks	
	Amount	Per Ct.	Amount	Per Ct.	Amount	Per Ct.
Dec. 9, 1892	$133	27.26	$142	28.68	$255	26.21
Mar. 6, 1893	129	26.51	139	29.47	254	25.93
May 4, 1893	133	28.30	133	28.56	237	24.47
July 12, 1893	106	26.24	118	29.20	231	26.80
Oct. 3, 1893	153	37.16	130	35.14	230	30.05
Dec. 19, 1893	218	41.55	166	36.16	251	31.65
Feb. 28, 1894	232	40.37	185	37.79	272	32.86
Jan. 26, 1907	326	26.74	364	25.85	418	16.59
Mar. 22, 1907	298	25.26	341	24.31	426	16.70
May 20, 1907	328	26.50	354	24.86	425	16.61
Aug. 22, 1907	315	26.18	362	25.46	443	16.88
Dec. 3, 1907	257	22.20	312	24.72	476	19.17
Feb. 14, 1908	360	28.62	360	27.37	461	18.75
May 14, 1908	423	29.70	389	27.87	455	18.40
July 15, 1908	418	27.85	400	27.44	449	17.92
Sept. 23, 1908	437	27.81	415	26.84	455	17.68

Taking the country banks first (in the table on the preceding page) it is observable that there was a very sharp constriction of loans and discounts (representing the amount of accommodation extended to the public) in the period between March 6, 1893, and

Increase of Reserves in Time of Stress

October 3, 1893. The loans and discounts fell from $1,267,000,000 to $970,000,000; and in the same period the individual deposits fell from $970,000,000 to $764,000,000. At the same time that the country banks as a whole were reducing their loans to the public, they were simultaneously increasing the percentage of their reserves to deposits from 25 to 30 per cent.

Likewise for the central reserve cities in the same period there was a decline of loans from $522,000,000 to $442,000,000; there was a corresponding decline in individual deposits from $404,000,000 to $352,000,000; and an increase in the percentage of reserves from 29 to 35 per cent. This again shows that in a time of crisis, when loans were most needed, the reserve city banks (other than central reserve cities) withdrew their assistance to the public and increased the percentage of their reserves; that is, in order to protect themselves, the banks sacrificed their customers.

Action of Central Reserve City Banks

It is to be observed that the banks of the central reserve cities acted more nearly after the fashion of the European banks. They were the holders of reserves for other banks, and when called upon for cash, they sent shipments out into the country and maintained their position by importing gold from abroad or by obtaining lawful money from the Treasury. In justice to these banks, it should be observed that loans on March 6, 1893, were $356,000,000; July 12, 1893, they had risen to the amount of $571,000,000; and October 3, 1893, they were $377,000,000. However, individual deposits fell from $374,000,000 March 6, 1893, to $330,000,000 October 3, 1893; and reserves increased in the same period from 26 to 37 per cent. Here again we see, even in the case of the central reserve cities, a tendency to the liquidation of deposits accompanied by an increase of percentage of reserves to deposits.

Similar lessons are to be drawn from experience during the panic of 1907. The loans of country banks as a whole fell from $2,272,000,000 March 22, 1907, to $2,198,000,000 February 14, 1908. In the same time, individual deposits fell from $2,502,000,000 to $2,411,000,000; and the percentage of reserves rose from 16 to more than 18 per cent. For the reserve cities (other than central reserve cities) the loans fell from $1,224,000,000 to $1,153,000,000; the deposits fell from $996,000,000 to $932,000,000; and reserves increased from 24 to 27 per cent. The banks in central reserve cities increased their loans from $1,039,000,000 to $1,070,000,000, while individual deposits changed from $770,000,000 to

$761,000,000, showing practically no change; while reserves increased from 25 to 28 per cent. Here again it will be observed that under our rigid reserve system, the country and the reserve city banks believed their only protection was to be found in an increase of actual cash reserves at the expense of the borrowing public. However, it is to the credit of the central reserve city banks that they met the demands for loans more nearly after the experience of foreign countries than did the banks depending upon them. The system as thus explained in the United States, however, stands out in striking contrast to the working of credit in times of panic in European countries.

Cash Reserves Increased at the Expense of the Borrowing Public

In studying the Bank of France, the items chosen are circulation, private deposits, commercial discounts and reserves. Circulation is here combined with private deposits because of the fact that during the periods of stringency in France circulation is more likely to be the form in which loans are completed than are deposits, while at all times the note issues constitute a far more important medium for the making of loans than do the deposits. Reviewing these figures, it is seen that the circulation of the Bank of France, which had been 3,144 million francs early in 1892, continued to rise steadily, reaching its maximum for the dates given on March 1, 1894, when it was 3,527 million francs. Meanwhile, the commercial discounts had risen from 672 million francs to 715 million francs. In 1907-08 the course of development was very similar. The bank had brought about a shrinkage in its note issues just before the stringency came on, so that at the end of May there were 4,686 million francs outstanding. As stringency developed, the notes expanded to 4,906 in December, and then to 4,832 million francs in February of the following year. The commercial discounts went through somewhat the same course of development, reaching a maximum of 1,255 million francs in December, when the stringency was at its height.

Bank of France

In the case of the Bank of France the figures for reserves show a substantially stable condition during the latter part of 1892 and practically the whole of 1893. Very little fluctuation occurred during those months. Although there was a material increase in commercial discounts during the middle of 1893, and a large increase in private deposits at the same time, both followed by a shrinkage, there was no effect on the reserves. The growth in circulation, which reached a maximum in July, 1893, not equaled during the preceding eighteen months or the follow-

ing nine months, was not paralleled by any corresponding movement in the stock of cash on hand. Reviewing the conditions during 1907 and the early part of 1908, it is seen that, although circulation reached its high point in December, 1907, and private deposits were larger on that date than they had been for many months, the same being true of commercial discounts, the reserve was decidedly smaller than it had been at the last preceding date (August, 1907), and was practically at the same level it had held for several months before that time. This again illustrates the fact already referred to that there was no disposition on the part of the Bank of France to increase its holdings of specie during a period of stringency, but that it was rather inclined to let the stock run down, notwithstanding the increase of accommodations to the public.

Effect on Reserves

BANK OF FRANCE
(In Francs; 000,000 omitted)

1892	Circulation	Private Deposits	Commercial Discounts	Reserves
Mar. 3	3,144,	441,	672,	2,653,
May 19	3,120,	485,	450,	2,825,
Juy 15	3,198,	401,	529,	2,900,
Sept. 29	3,136,	440,	506,	2,969
Dec. 8	3,239,	391,	491,	2,968,
1893				
Mar. 2	3,455,	420,	572,	2,924,
May 4	3,499,	409,	552,	2,973,
July 13	3,501,	411,	634,	2,987,
Oct. 5	3,467,	363,	526,	2,966,
Des. 21	3,437,	386,	550,	2,982,
1894				
Mar. 1	3,527,	382,	715,	2,980,
1907				
Jan. 24	4,833,	513,	1,212,	2,639,
Mar. 21	4,737,	537,	1,101,	3,591,
May 23	4,686,	507,	1,050,	3,616,
Aug. 22	4,598,	463,	855,	3,780,
Dec. 5	4,906,	512,	1,255,	3,622,
1908				
Feb. 13	4,832,	483,	1,098,	3,650,

In the case of the German Reichsbank, the figures chosen for tabulation are bills discounted, notes, other demand liabilities and coin. The notes and other demand liabilities represent the forms in which credit was extended to the commercial public, while the bills discounted represent the assets in the form of commercial paper received by the banks. In 1892 the bills discounted by the bank were about 544 million marks. This figure rose steadily during the period of stringency, reaching its maximum in October, 1893, with 638 million marks, after which shrinkage occurred as the stringency abated. The course of development in the note issues was very similar. Demand liabilities other than notes shrank

German Reichsbank

during 1892, then increased again as the business public began to demand more accommodation in the form of deposit accounts. Yet the bank was willing to pay reserves, while increasing loans in order to aid the public. The coin held by the bank shrank a good deal more than 100,000,000 marks during 1892, recovered only moderately at the opening of 1893; but fell nearly 200,000,000 marks in 1893, and reached a low point in the latter part of the year. Yet while the coin on hand was thus falling off, notes were increasing to their maximum (October, 1893), while the same was true of bills discounted.

Paid Out Reserves and Increased Loans

In 1907, the bills discounted gradually increased as the stringency grew more intense, while the notes went through the same course of expansion, reaching a maximum in December, 1907. Other demand liabilities had reached a maximum early in the year, and shrank during the panic period, when loans were taken largely in the form of notes. Then, as business men began to demand accommodation in the deposit form more and more, the other demand liabilities expanded at the time when they were shrinking in the United States. A condition similar to that in 1893 existed during 1907 in regard to reserves. The low point in coin holdings was reached in December simultaneously with the high point in bills discounted and in notes issued. That is, as contrasted with our contraction of loans and increase of reserves in a time of real need by borrowers, the Reichsbank increased its loans, as shown by the increase of its immediate liabilities, at the very time when it was meeting demands for cash by paying out its reserves.

GERMAN REICHSBANK
(In Marks; 000 omitted)

	Bills Discounted	Notes	Other Demand Liabilities	Coin
1892				
Feb. 29	544,039	891,506	636,561	978,390
May 15	536,445	940,408	583,057	971,862
July 15	535,787	993,858	552,133	988,187
Sept. 30	599,389	114,825	394,280	888,473
Dec. 7	544,931	993,135	419,011	866,142
1893				
Mar. 7	465,500	926,134	456,280	919,376
May 7	643,967	990,415	543,552	864,587
July 15	665,483	1,012,585	462,999	808,533
Oct. 7	638,876	1,061,791	346,088	739,746
Dec. 15	514,180	948,817	431,750	839,519
1894				
Feb. 28	508,916	908,572	501,139	913,469
1907				
Jan. 31	938,131	1,411,818	515,044	843,304
Mar. 23	1,011,814	1,351,832	660,347	918,369
May 23	1,001,818	1,351,136	742,413	984,802
Aug. 23	1,034,439	1,360,334	616,208	936,664
Dec. 7	1,241,400	1,468,555	475,715	681,760
Dec. 31	1,493,593	1,885,922	658,502	704,179

Bank of England

In representing the course of business at the Banking Department of the Bank of England there are tabulated the figures showing total deposits, seven-day bills, and reserves. For the period 1892-93, it will be observed that there was a shrinkage during the period before the breaking out of the panic, the low point being reached early in December, 1892, when the figures show £32,637. This figure steadily increased until it reached £40,135 in July, 1893. Subsequently, there was another shrinkage and then an upward trend. The specie holdings of the Bank of England during the panic period, 1892-94, reached their maximum in July, 1893, but promptly fell off during the latter part of the year. There was no corresponding shrinkage in deposits and seven-day bills, and an inspection of the figures shows that at times when the amount of these accommodations was growing rapidly as was the case early in 1893, reserve funds were falling heavily. The smallest sum of reserve held was in May, 1893, at a time when the deposits and seven-day bills stood at a figure nearly as high as any that was reached during the whole period.

BANK OF ENGLAND

	Total Deposits and Seven-Day Bills	Reserve Notes and Specie
1892		
Mar. 2	£38,688,000	£16,415,000
May 18	36,875,000	16,048,000
July 13	36,922,000	16,602,000
Sept. 28	35,068,000	17,229,000
Dec. 7	32,637,000	15,652,000
1893		
Mar. 1	37,192,000	18,623,000
May 3	36,281,000	15,011,000
July 12	40,135,000	19,114,000
Oct. 4	36,585,000	16,654,000
Dec. 20	32,177,000	16,149,000
1894		
Feb. 28	39,176,000	22,893,000
1907		
Jan. 23	49,482,000	24,206,000
Mar. 20	60,271,000	26,524,000
May 22	52,697,000	24,680,000
Aug. 21	49,322,000	24,959,000
Dec. 4	49,896,000	21,909,000
1908		
Feb. 12	53,510,000	28,618,000

During the year 1907 there was a high point of deposits at £60,271 in March, which was reduced in May and August. The figure remained about stationary from that time until about the end of the year, then expanded, while accommodations in the United States were shrinking. During 1907-08, the low period in holdings of reserve funds was reached in December, that being practically the most severe moment of strain, while at the same

time accommodations in the form of deposits and seven-day bills, although not at a maximum, stood at a figure fully up to the general average. The way in which the bank extended accommodation can be seen from the fact that when the strain of the panic was relaxed early in 1908, specie was increased by about one-third, while only a moderate increase in accommodations took place.

In all of this discussion it should be borne in mind, of course, that the periods of most severe stringency do not exactly coincide in the several countries. The dates chosen, however, have been selected as nearly as possible to correspond. If more dates were given, the course of the expansion of banking accommodation could be more closely followed in each of the countries. But enough has been said to explain the essential difference between foreign countries and those of the United States in the matter of banking accommodation. This may be summed up in the statement that whereas foreign banking systems are able to increase their accommodation in times of special need for it, American banks must curtail. Coincident with this situation is the condition which leads to the piling up of reserve funds in American banks at the same time that their accommodations are being shortened, whereas in foreign banks, although there is a natural disposition to strengthen the reserve as opportunity favors, particularly by importations of specie from abroad, there is no hesitation about letting the reserve stock run down if by so doing the commercial community can be materially helped. It naturally appears that this relaxation of the effort to maintain a large specie stock occurs coincidently with the increasing of current accommodation.

Comparison with United States

§4. In the foregoing comparison, and generally throughout the discussion in this chapter thus far, reference has been made to periods of special stringency or panic as if they were the chief or only occasions upon which difficulty of the kind referred to was encountered. This is far from being the case. The periods referred to have been mentioned simply because they afford a clearer illustration of the essential defect in the reserve requirements of the national system than could be had from an analysis of conditions at other times. The fact remains that periods of special strain are in no respect peculiar, or different in their nature from others. They are simply times at which essential weaknesses show themselves more obviously than at others. This means that the traits which are developed at those moments are seen at all times,

Crises Bring Out Abiding Defects

although less intelligibly and certainly at some than at others. The national banking system, under present circumstances, contracts its loans and raises their price at the very moment, important or unimportant, when there is a special call for funds. When there is no such call it relaxes its grasp upon business, money becomes easy and borrowing is stimulated.

If we had such an organization of business that the demand for loans was about as great at one period of the year as another, this peculiarity of the system would not be noticeable. The fact is, however, that demands for loans differ greatly, not only between years of stringency and years of easy money, but also between different seasons in the same year. There are many occasions when an exceptional demand for loans makes itself felt and when the loans are correspondingly hard to get. The best known example of this sort is seen in the case of the crop-moving period. The peculiarities of crop moving are dealt with later in the present study.[1] At this point it is enough to say that the crop-moving period is, for reasons to be noted later, a period of special demand for funds with certain classes of banks. These banks are so widely diffused that the crop-moving season may be said to be an occasion of special demand for loans throughout the whole country. Under the present organization it is, however, a period when loans are exceptionally hard to get and their price is exceptionally high.

Seasonal Strains

The situation is aggravated, as we shall later see, by the fact that at those seasons of the year and in those parts of the country where crop moving is active, the demand for bank credit in the form of note issues is unusually strong. This tends to accentuate the high cost of loans when the latter are taken in the form of notes, and may at times so shift the balance of demand from those forms of bank credit which take shape as deposit accounts as to leave the latter form of credit available in some parts of the country at exceptionally low figures. This, however, is merely an accidental feature of the problem. The fundamental fact is that at those seasons credit becomes high in price, loans are reluctantly granted by many banks, and an effort is made to keep control of specie, notwithstanding that this is the very time when reserves should be allowed to run down in response to legitimate demands, and when every effort should be made to cheapen the crop-moving process by reducing the cost of accommodation on perfectly sound

Demand for Notes

[1] Chapter XVIII.

paper growing out of business requirements. The difficulty is inherent in the reserve system of the national banking law.

§5. In Chapter 1 the outlines of the present system of redepositing reserves were made familiar. What has just been said suggests that as the system of scattering reserves tends to create an undue anxiety on the part of banks to build up reserves just when loans are wanted and when the reverse policy should be pursued, so the system of redepositing reserves has an opposite and, in some respects, an equally bad effect. Under the scattered reserve system, when money is "easy," isolated banks are desirous of finding some way to employ their funds. The reserve system tends to draw these funds to the commercial centers, and particularly to New York, whenever business throughout the country is slack. Under those conditions, the prospect of earning a rate of interest, or some similar reason, attracts the funds of the country banks to the reserve cities.

Redepositing Reserves Has a Bad Effect

Occasionally the funds are not redeposited with banks in these centers under the reserve system, but are simply sent to brokers and others who offer them on loan at the highest rate of interest that is attainable. The effect of this system is to create a feverish market for loan capital under certain well-marked conditions. The drifting of the funds to New York and other centers of speculation necessarily enables much speculation to flourish which would not exist if it were not for the offering of low rates of interest on deposits. These low rates, however, open the possibility of doing some profitable business, even when the fluctuations in stocks are not very wide.

Funds Drift to Centers

The question is often asked why the drifting of the bank funds to the centers does not make the use of the funds to commercial interests as free and as cheap as to speculative interests. The reason is that these funds constitute a part of the reserve of the banks when they are deposited with other banks in the centers. Even when peddled out by banks to borrowers through private bankers, loan offices and brokers, they constitute a part of the available liquid funds of the banks. They have therefore to be within at least moderately easy reach. They could not be loaned on time, since that would imply the creation of time paper, which would be of no service unless it could be rediscounted. The banks naturally feel that they can lend their funds in this way

Why These Funds Do Not Go to Commercial Borrowers

only upon demand or call. No regular merchant feels that he can afford to borrow funds upon call. The risk of being asked to make payments at times when he can least afford to do so is far too great. Ordinarily, he would rather not borrow at all —and correspondingly limit his operations—than borrow on call, unless the case is one of extreme necessity. Speculators, on the other hand, usually prefer the call loan type of borrowing. They want to make quick "turns," and the condition of the stock market, or produce exchanges, frequently permits them to do so. If they can get the use of cash, even for a few days at a time, provided it does not cost them too much, they are willing to take it. The opportunity for lending such funds as have been spoken of therefore is practically limited to the call loan field.

Call Loans and Speculation

There is another aspect of this same matter which seems opposed to the views already expressed, although it really is not so. In what has been said, the suggestion has been offered that the loans most frequently made are made at low rates and on call, due to the fact that speculators are encouraged to take the funds because of their cheapness. This is usually the case. There are some occasions, however, when precisely the converse of this situation exists. In the case of a severe stringency or panic it may be absolutely imperative for speculators who have committed themselves very heavily to get the use of funds for a short time. Under those conditions the speculators stand ready to pay abnormally high rates in order to get the command of funds for a short period.

Very quickly the banks of New York City, or any other similarly situated place, find themselves heavily burdened with loans. Many of the loans which they will be found to be carrying under such conditions are necessarily loans based on collateral, either directly or indirectly. The banks do not feel like enlarging their liabilities of this kind. Consequently, a limit is very easily reached to what the banks can do, and speculators find themselves obliged to turn to banks in other places. The question is then opened whether such other banks will be willing to furnish the funds needed, if by so doing they endanger the welfare of their own customers. Occasionally such a danger may be consciously incurred because the banks want to profit by the high rates of interest at a distance. If a national bank thus wilfully puts out of its hands the funds which have been entrusted to it by the community, and which should be used in that community so long as

Robbing Legitimate Business

there is a need for them, it places its local customers at an undeserved disadvantage, and it does this for the sake of furthering the enterprises of remote speculators.

More frequently, however, the local national banks do not intend anything of this sort. They know that they have a small sum to spare and are tempted by offers of high rates of interest to let it go. When they have thus weakened themselves, unexpected calls are made by local customers. It becomes impossible to provide for the local business men; and thus, without any wrong intention on the part of the banks, the regular customers are subjected to the same bad conditions as if the bank had voluntarily separated the community from the loanable funds which it should have kept within reach. This necessarily means either that the community must go without the banking accommodation it needs or else that it must appeal to other communities and pay high rates of interest in order to get its loans. In other words, business and industrial interests are obliged to bid for accommodation on a parity with speculators who have been pinched in stock or produce exchange operations.

Legitimate Borrowers on Par with Speculators

Where these conditions exist in most aggravated form, the effect is to deprive regular borrowers of the advantage of very low rates, but to impose upon them the disadvantage of the highest rates that prevailed from time to time. That is, commercial rates of interest are made to depend upon speculative rates. Of course, this necessarily means that the expense of speculation is in considerable measure added to the expense of obtaining regular and legitimate loans. Even when that has been said, no account is taken of the burden and, perhaps, destructive influence, that has resulted from the withholding of reliable loans at moderate rates when the community had a right to expect that they would be made, but when, in fact, they had been rendered impossible. The difficulty with the national system in this respect is twofold. It grows out of the entire lack of any coöperative reserve system which might serve to control the movement of funds between different parts of the country. It also results in large measure from the great diffusion of reserves among different communities which prevents any adequate estimate or adjustment of regular demands for accommodation.

Business Rates Depend on Speculation Rates

§6. The defects of the system of redepositing reserves and the tendency of this system to promote speculation need not be

regarded as the only factors tending to increase the cost of loans to the community and to render them irregular and disproportionate between different communities. It must be conceded that the system of diffused reserves implies a high cost of loans, even under the most favorable conditions. That is, a system which requires an unnecessarily large amount of reserves, unproductive in the form of cash, is an expense to the banking community, inevitably falling in the end upon the borrower in a higher rate of discount.

Our Reserve System Implies High Cost of Loans

Bearing in mind that the diffused reserve system is necessarily closely associated with the peculiar characteristics of the discount market in the United States, it can be understood that the maintenance of reserves is very closely dependent upon the existence of a satisfactory and active market for paper. Great economies in bank operation could be effected if banks could be certain of a prompt and reliable market for their paper, so that they could feel sure of always being able to replenish their reserves whenever circumstances demanded. Under such conditions, reserves could safely be allowed to run down to a much lower figure than would otherwise be prudent. At present the maintenance of a considerable cash reserve by any bank which is doing an active business is practically unavoidable, since it cannot have the assurance of being able to rediscount or market its paper at favorable rates without delay whenever it may desire more funds. It is therefore obliged to keep on hand, and in an idle condition, considerable quantities of reserve money.

Discount Market Would Reduce Amount of Reserves Needed

This reserve is necessary in any system of isolated and independent banks. The framers of the national bank act tried to reduce the cost of carrying reserves as much as possible by permitting the redepositing of reserves with banks in reserve cities and central reserve cities. But these banks themselves can pay only a low rate of interest upon such reserves when left with them subject to call. The payment of this interest is frequently an unfortunate thing, both for the bank which gives it and the bank which receives it, for more reasons than one; but, whether it be paid or not, the fact remains that the redeposit system, as applied to reserves, does not materially lower the cost of carrying on the banks. This is where the branch bank system has its greatest advantage in the matter of expense—it does not require the payment of a large reserve fund into distant vaults, where it may remain idle almost indefinitely. On the other hand, a plan which would avoid the present necessity of keeping unnecessary reserves,

Branch Banks Save Unnecessary Reserves

by providing some coöperative system for their mobilization, would largely eliminate this element of cost.

Meantime, the high cost of independent banking continues to be one of the serious defects of the national system, both by depriving small communities of credit facilities and by raising the cost of loans at country banks. The fact that the country banks' customers are obliged to pay a higher rate of interest for their accommodation than customers in cities is often explained on the ground that the paper presented to the country banks contains a larger element of risk than does that presented to the city banks. This may or may not be true; but even if the paper were of the same grade the differences in the rates of discount would exist for the reasons already stated. That it is not necessary to have such a difference is seen from the experience of Canada, whose system of business and agricultural organization is very similar to that of the United States. A comparison of interest rates at various points in the United States, compiled from the reports of about 6.000 country banks, makes the following showing:

High Rates In Country Districts

	Time Loans.	Demand Loans.
New England States		
Maine	5.85	5.67
New Hampshire	5.48	5.55
Vermont	5.88	5.78
Massachusetts	5.31	5.10
Rhode Island	5.30	5.21
Connecticut	5.56	5.11
Average	5.53	5.31
Eastern States		
New York	5.85	5.63
New Jersey	5.80	5.52
Pennsylvania	5.51	5.67
Delaware	5.80	5.51
Maryland	5.83	5.63
Dist. of Columbia	5.70	5.07
Average	5.66	5.63
Southern States		
Virginia	6.06	5.93
West Virginia	4.82	4.54
North Carolina	6.50	6.28
South Carolina	7.32	7.01
Georgia	8.49	8.10
Florida	8.35	8.07
Alabama	8.74	8.08
Mississippi	8.60	8.26
Louisiana	7.72	7.22
Texas	9.57	9.19
Arkansas	9.10	8.10
Kentucky	6.58	6.14
Tennessee	7.29	6.87
Average	7.99	7.63
Middle States		
Ohio	6.09	5.80
Indiara	6.32	5.50
Illinois	6.51	6.08
Michigan	6.16	5.99
Wisconsin	6.01	5.84
Minnesota	6.67	6.93
Iowa	7.36	7.19
Missouri	7.60	6.68
Average	6.55	6.25
Western States		
North Dakota	10.43	9.72
South Dakota	8.69	8.51
Nebraska	7.87	7.55
Kansas	8.03	7.19
Montana	9.78	9.58
Wyoming	9.15	9.30
Colorado	8.94	8.09
New Mexico	10.12	10.12
Oklahoma	12.60	9.85
Average	9.27	8.70
Pacific States		
Washington	8.57	8.55
Oregon	8.14	7.99
California	6.61	7.14
Idaho	9.63	9.50
Utah	8.34	8.16
Nevada	9.40	9.82
Arizona	9.76	9.70
Alaska	11.50	11.50
Average	7.83	7.76
Average for the United States	7.33	7.00

A feature of the national banking system to which comparatively little attention has been given by those who have compared it with foreign countries is found in the lack of credit facilities afforded to small places. The national banking system, organized as it has been upon a basis of entire independence in banking, has naturally limited the size of the institutions that could be established. The framers of the national act did not feel that a bank could be safely organized with a capital of less than $50,000. This continued to be the lower limit of capitalization until the year 1900, when the limit was placed at $25,000. National banks may therefore be organized today with capital not exceeding $25,000, if they are located in towns having a population of not over 3,000 persons. Of course, the practice of limiting banks with reference to capitalization means that the very smallest places cannot be taken care of, but must look to others to supply them with credit facilities. This, in fact, is the method which they have followed. State and private banks of very much smaller capitals, running as low as $5,000, have been organized in the most minute units of population.

Need of Small Banks Supplied by States

The reason why even these small banks cannot be maintained in some places is that the expense of carrying them on is too great in proportion to the amount of business offering in those places. Unless a bank can make a fair return upon its capital it necessarily seeks some other field. Yet in foreign countries banking facilities are provided in places which are deprived of them in the United States where the business is unprofitable. It is possible to extend the facilities there by the use of the branch bank system. No such system exists in the United States, and no one now proposes to introduce it. Yet it would be highly desirable if the advantages offered by the branch bank system could be furnished here through adjustments of the cost of carrying on banks by economies in reserves and otherwise.

Advantages of Branches Obtained by a Coöperative Agency

§7. The hoarding of cash in the manner described, and the failure to afford commercial loans when they are needed, have many indirect effects that are not so obvious as those immediately related to the banking system itself. One of these is the influence produced by the credit system of the national banks upon prices of goods. Bank credit—the cost of borrowed capital—is a regular element in the expenses of production of every large business. If credit is high in price, the expenses of carrying on the business

High Cost of Credit Raises Prices

are correspondingly raised; if it is low, they are correspondingly reduced. Bank credit is costly when the expenses to the bank involved in supplying it are high. This occurs whenever too little facility exists for the extension of loans at the times when they are most needed. Instead of expanding these loans to meet larger volumes of business, the banker under the present system almost necessarily shortens his loans, usually raising his rate at the same time. The result, in the long run, is to necessitate higher prices for commodities in consequence of the expensiveness of bank credit.

This condition is not so marked in commercial centers, or even in manufacturing towns, as it is in the rural districts. It is seen in aggravated form in some agricultural regions where rates of discount are extravagantly high, due partly to the inability to obtain rediscounts from other banks on the paper which originates in these communities, and partly to the relatively large volume of money which is required in order to provide a basis for the loans in the community. This situation arises wherever the custom of the community calls for actual currency, and where the only kind of currency that can be had is that which the bank borrows from some other institution at a high rate of interest.

Workings In Agricultural Districts

The high prices which are so frequently referred to by superficial thinkers on money as growing out of the presence of a large volume of money in the community, are really due to an entirely different circumstance. They are the result of costly bank credit resulting from a clumsy banking mechanism, which necessarily calls a large volume of cash to its aid, as an inexperienced swimmer requires an unnecessarily large amount of supporting power to keep him from sinking. The large quantity of money held in the circulation is the concomitant of the high prices which have been partly due to the use of primitive banking methods.

High Prices Not Due to Large Volume of Money

This failure of the banks to coöperate successfully and economically with the business community is aggravated by the difficulty of selling local paper in other parts of the country. The paper in the hands of the small bank in a remote spot may be excellent, yet may be entirely unsalable at a distance, owing to a lack of knowledge in other banking institutions concerning the character of the paper of the given locality. Inasmuch as this general ignorance could only be repaired through some agency like the bank itself, and inasmuch as the bank is itself interested to sell the paper to the institution from which it is seeking accommodation, the latter has no impartial way of testing the paper.

Country Paper at a Disadvantage

This is one of the most serious defects of the national banking system, and is very nearly peculiar to it. In foreign countries local paper is tested through branches representing larger institutions, or through coöperative effort on the part of several banks, or otherwise. Nothing of the kind exists here. Paper offered for rediscount to distant financial institutions must rest entirely upon the credit of the bank itself and of the maker of the paper.

It is this local character in our paper which renders it hard for banks to aid other banks with the conviction that in so doing they are not inflicting an injustice upon their own stockholders and creditors.

Local Industries Obliged to Go Elsewhere for Loans

§8. Conversely, the conditions which have just been described operate to obstruct the getting of loans by large concerns which need them and are entitled to them. It frequently happens that a large business house of unquestioned solvency and ability finds that it cannot float its paper with the local banks in the place where it is situated. This is not because of untrustworthiness on its part, but it may be simply that the concern does not feel like paying the high rate of interest that is demanded by the local banks in consequence of the general condition of credit prevailing there at that time. Either the banks are not willing to take the paper at all, simply because they are overloaded, or else they are willing to take it, but at so high a rate of interest that it would not be worth while for the concern to use more capital in that way.

Present Objections to Widely Scattered Paper

Under such conditions the business may place its paper in the hands of note-brokers, who dispose of it in communities where the banking system is able to provide further loans, and where therefore it is not difficult to float the paper at a reasonable rate of interest. This operation has two serious objections: It requires time; and the cost involved in paying the note-broker is large when compared with the total cost of the loan. Added to these is the fact that where paper is thus distributed very widely the buying banks cannot judge of its character, while the door is opened for irregularity and deception on the part of unscrupulous persons.

But it should be clearly understood that however the paper may be floated and wherever banks may be induced to take it up, the whole question is merely that of the supply of bank funds as compared with the demand for them. The bank in the large city which is visited by a known and tried customer would be glad to

extend accommodation to him if it could feel any assurance of being able to convert the unquestionably sound paper thus furnished him into immediate funds in the event of necessity. It does not dare to go beyond a certain point, because it knows that there may be danger. The reason for danger is that the possibility is recognized that customers or depositors may suddenly converge upon the bank with a demand for cash. So, in seeking accommodation, the borrower finds it necessary, simply because there is no general discount market in the United States, to hunt up the banks which still have a surplus of lending power within their control—that is, which are not "loaned up" to their limit or to the limit of safety. Whether a demand converges on the large bank in a city, or whether it appears at the small bank in the country, the effect is the same. There is no difference in the character of the problem. The large bank, if anything, is in a proportionately less stable position and has to protect itself more carefully, because many of its customers are small banks, and their demand, when exerted, is a demand for actual cash with which to supply their own reserves.

Lack of Discount Market Limits Loans

§9. It is clear that the evil which most urgently demands correction in the present reserve system is its rigidity. But it is equally clear that this evil cannot be corrected by merely allowing banks under existing conditions to regulate their reserves at pleasure. To permit them to do so would, no doubt, be beneficial in many instances, since it would result in permitting the banks to use their own judgment more freely about letting cash run down when circumstances seemed to require such action. Probably, in other cases, such a change would not be beneficial, and in some would be injurious. The real evil can be corrected only by the establishment of a means of getting rediscounts, or of obtaining accommodation, from a source which can be relied upon to supply the banks with current funds for the replenishment of their reserves, so long as they can present live commercial paper, running for short periods, and growing out of legitimate commercial transaction. This can be accomplished only through the establishment of a coöperative system which will permit the joint control of reserves so as to practically place the spare funds of all parts of the country at the service of each when circumstances may require it. An improved system of joint control of reserves created by the harmonious action of the banks themselves acting together,

Remedy In Unity and Coöperation

and working through the medium of an open discount market, would substitute for the present system of scattered and competitive reserves a plan which would afford the strength of unity and coöperation.

CHAPTER IV

OUR INELASTIC CREDIT SYSTEM

1. Panic Conditions—2. Dangerous Grasping for Reserves—3. Ways of Converting Assets Into Immediate Means of Payment—4. Bank Notes Not a Desirable Remedy for Panics—5. Remedy Must Touch Lending Power of Banks—6. Restoration of Confidence if Assets Good—7. Experience of Other Countries—8. Remedies for Panics Not in Temporary Measures—9. Importation of Gold for Reserves.

§1. In preceding chapters reference has been made to the fact that at periods of panic or stringency the national banks under existing conditions shorten their loans and restrict accommodation. This was noted as merely one example of the way in which the present reserve system tends to limit accommodation when it is much needed, while granting it when it is not so much needed. Although the general rigidity of the system, existing as it does at all times and in all places, is the really serious element in the banking problem of today, attention has rightly been given to the tendency of the system to fail just at the most critical period and thereby to prevent the attainment of relief at times when such relief is absolutely necessary. The relation of the banking system to panics and crises has therefore received an exceptional amount of study and has sometimes been spoken of as if it were a special problem. It, however, is not that; but it is, as already noted, a special case of a general problem. It is worthy of independent discussion, however, because at periods of stringency the effects of various measures of relief upon the commercial community can be clearly traced. Lessons are thus indicated for the conduct of affairs in normal times.

Breakdown of Our System In Panics Part of General Problem

The course of a commercial disturbance of the sort referred to is somewhat as follows. Difficulty at the banks is indicated by the fact that they are unable to extend accommodation as it is wanted to regular customers. Probably for some time preceding, bank liabilities have been increasing, while cash has either barely held its own, or has fallen off. The bank endeavors to secure means

Events Leading to a Panic

to make further loans by appealing to other banks for accommodation. But on such occasions these other banks are themselves crippled in somewhat the same way; or they are appealed to by so many institutions that they cannot furnish the aid that is called for, at least not in the amount that is needed. The banks then find themselves in danger of a decline of their reserves below the legal minimum or, perhaps, even below the line which experience has marked out as the margin of safety. In such cases the only resource is to refuse loans to the business public. This means that extensions cannot be had in some cases, while in others men who had confidently expected to receive more accommodation are cut off. Consequently, they do not find it possible to pay others and a so-called lack of confidence is developed.

Lack of Confidence Restricts Sales of Goods

If a time arrives when it is generally realized by the business community that the activity of the operations in a particular line, or perhaps in all lines, has gone too far, and that the upward trend of prices has reached its limit, the result is likely to be a sudden falling off in demand, or an inability to make sales of goods or property, which must be disposed of in order to liquidate the obligations that have been incurred by owners, who have taken it over from others at a valuation that is now seen to be too high. This check to business tends to restrict sales, and makes it necessary for those who have obtained accommodation at banks to secure extensions of time in order that they may be given a greater opportunity to collect what is due them from others, or to dispose of the goods they have on hand in a manner sufficiently profitable to enable them to clear themselves and liquidate their indebtedness.

The banks must then decide whether they can afford to make this extension. To do so will deprive them of immediate resources either in cash or in claims on other banks which they had expected. It may be a serious matter to the banks to grant an extension of the accommodation, because they may be called on to do so at a time when their resources are running so low as to put them in danger. If at this particular juncture, the banks being unable to collect what is due them, depositors holding demand liabilities of some bank or banks begin to demand the actual liquidation of these liabilities in cash, the bank or banks thus affected may be placed in a very embarrassing position. They may find themselves face to face with an empty vault, while demand liabilities are still being presented at the counter for liquidation.

§2. Meanwhile, if the smaller banks have had funds on deposit with other banks, they have probably drawn them down to some extent. True, they are allowed to count these funds as part of their reserves, but the reserve city and central reserve city banks which require large stocks of lawful money in their vaults have usually had to call in all items due from other banks. The first result of this situation is a general tightening of credit, a shortening of the balances on hand in banks due to other banks, and presently a reduction of individual bank balances or deposits as these are gradually used to liquidate outstanding obligations. As the deposits are drawn upon, those to whom they are paid away may either redeposit them or draw them out by asking the banks for cash. Before the stringency is far advanced, a good many persons are choosing the cash alternative, and are thereby putting the banks in an embarrassing position. The more cash the banks pay out, the less able they are to extend credit, and since they cannot get further accommodation or rediscounts at other banks, their difficulty is likely to be very serious.

Grasping for Reserves

Of course, all this would be remedied if there were some general means for expanding loans just at the time when they are most needed, or if it had been possible, in anticipation, to penalize the banks by taxation or otherwise for their action in allowing themselves to become so short of funds. But the national banking system makes no provision for such relief. Its regulations are rigid and require the maintenance of a given amount of reserve. Even when these regulations are stretched to the utmost and the banks let their reserves run down, in order to continue extending accommodations, the fact that there is no fixed relationship between the banks makes it possible for selfish institutions, so to speak, to help themselves to the country's stock of cash. They play the part of dogs in the manger, accumulating cash in their vaults often to guard against a fancied threat rather than any real harm. Although they are precisely the institutions which ought to be helpful and inclined to place their funds at the disposal of the community, those banks which are in most liquid condition are able to practice this kind of selfishness to the greatest extent.

No Co-operation Exists to Prevent Selfish Action

Very often this process of hoarding is carried to an extreme. During the panic of 1907, there was a mad rush for actual money, and many local banks grasped all that they could get, piling the coin and currency in their vaults and advertising the fact to the

public. In some cases this unnecessary reserve was raised as high as 50, or even 75 per cent of outstanding liabilities. The cash, if left in the hands of other banks, would have enabled many which got into difficulties, to keep afloat, and at the same time to supply the needs of borrowers who were looking to them for aid. It did not require conduct of this kind on the part of a very large number of banks to make the existing stock of cash inadequate. The visible supply was speedily shortened below the danger line, and then the only resource lay in some extraordinary methods, such as suspension of payments, issue of clearing-house certificates, or some other equally drastic measure.

Hoarding Reserves In 1907

§3. All that has been said thus far is based upon the assumption that the operations of the banks have been essentially conservative and sound, and that the paper they hold is absolutely valid and can be collected. There is supposed to be no bad paper, nor losses due to favoritism or dishonesty. If such losses occur, they, of course, aggravate the situation, and when they become known they still further stimulate public alarm. It is not necessary that such losses should go to the extent of exhausting the bank's surplus, or even its capital, for them to be a very serious factor affecting its status. Knowledge that such losses have occurred arouses suspicion and fear, and within a very short time the desire of creditors to secure liquidation from the banks is heightened to an abnormal extent. This, however, is more usually due to the conduct of individual banks than to the banking system as a whole. Panic conditions and lack of confidence, on the other hand, can be developed without any imprudence or over-extension on the part of banks, simply as a result of undue speculation or expansion on the part of the business community. However it originates, the problem by which banks are confronted at a time of panic or crisis —supposing their assets to be perfectly good and well protected— is that of converting their resources into immediate funds. They must find some way of satisfying the demands that are made upon them by individuals for means of payment that are available without any delay and can be used in the satisfaction of debts.

Aggravation of Alarm by Losses

Need of Converting Assets into Means of Payment

The current supposition is that the "immediate funds" which are thus wanted must take the form of "money." This idea probably grows out of the belief that in times of panic or stringency the banks which have money in their vaults are deemed safe, and

find it easy to allay fears concerning their ability to redeem. Hence, the conviction in many quarters that what is wanted on such occasions is a means of issuing money in the form of "notes." Out of this belief have grown the many futile schemes for providing an issue of "emergency currency." The truth is that such an emergency currency can be of use only in case the recipient of it confidingly believes that the bank has actually liquidated its debt to him by issuing a debt in a different form. When a panic comes on, many people find themselves the holders of claims against the banks. These claims may be in the form of deposit credits or they may be in the form of notes. If they are already in the latter shape, the presentation of notes at the banks for redemption cannot be met by the issue of other notes—in that case, the trouble would be that the bank was already finding it hard to sustain its outstanding note issue by redemption in lawful money. If the outstanding claims are in the form of deposit credits, depositors will not be satisfied in a period of distrust by the exchange of these credits for the bank's own notes, since these are merely another form of its obligation. The power to issue more notes of its own, therefore, is not, as a general principle, a satisfactory way of providing it with what we have called available funds.

Changing One Liability for Another

Only under one condition can notes supply this need. If they are protected in some special way, as for example by a joint guaranty on the part of other banks (as in the Canadian system), creditors of the bank may feel better satisfied if they have in their possession an obligation guaranteed by all of the banks, than they would be if they simply had the note of one bank. Their fears may, therefore, be allayed by giving them notes thus guaranteed, in exchange for the deposit credits, which are valid only against the bank which granted them. In this case the situation may be relieved by the issue of notes of the kind indicated. But it should be noted that what has been done here has been to grant relief by substituting the obligation of a group of banks for the obligation of a single bank.

Validation of Bank Notes by a Joint Guaranty

In the same way, relief may be obtained if, under a bond security system, certain portions of bank assets known as bonds which are of unquestionable soundness, can be segregated, and notes issued against them, preferably under governmental regulation. Men may be willing to accept these notes in liquidation of the claims they hold against the bank even though they may not be a legal

tender. In this case, the situation has been met, as before, by substituting a claim upon a certain kind of acceptable assets for a claim upon other assets which were distrusted. In one instance, there was substituted an obligation guaranteed by all of the banks and perhaps protected by a special redemption fund; in the other there was substituted a lien upon certain particular portions of the banks' assets, so that the recipient of the notes occupied the position of a preferred creditor protected by a special and unquestionable form of security. Neither transaction has anything whatever to do with a supposed "shortage of currency" or "amount of money" in the country The transaction has been simply the exchange of a better or more valid claim for one which was believed to be less secure.

Notes Validated by Segregation of Assets In Form of Bonds

As we have expressed it above, the demand in a time of panic or stringency is for immediate funds, and, as just explained, the meaning of this term is simply a means of payment. Evidently any other means of payment which would grant the same feeling of security would attain the same result. Available, or immediate, funds might be obtained by having the directors of the bank—if men of known solvency or wealth—personally endorse, or obligate themselves to pay, the claims of the creditors of the bank. This expedient has been tried in some instances with decided success where the credit of the directors was well known and above reproach.

Means of Payment Through Personal Guaranty

But immediate funds might be obtained in any one of several other ways. If it were possible for an institution, A, hard pressed by its depositors, to take some of its paper to another institution, B, and secure a discount there, A would be relieved just as satisfactorily as if an issue of its own new notes (secured as above indicated) had been obtained. Moreover, if the rediscount brought forth from B lawful money, or a deposit-account which could be counted in its reserves, the lending power of A would be increased far more than by any issue of notes. True, the turning over of this money to the bank, A, would withdraw that amount of cash from use elsewhere. But if B, the institution which rediscounted the paper, were itself authorized to issue notes, the relief to the bank, A, obtaining the rediscount would be the same as before, provided these notes were acceptable to the community (even if not lawful reserve money). That is to say, the bank would now be able to substitute the obligations of a larger, stronger, and better-known institution for its own, and the community would be satisfied be-

Notes of Another Institution Obtained by Rediscount

cause it would feel more assurance of the solvency of these notes. The institution would in reality have guaranteed certain assets of the bank and segregated them for the protection of certain creditors. Thus precisely the same object would have been obtained as in the other case considered.

But this same end could be arrived at equally as well in still another way. The demands made upon banks in times of panic do not all come from the outside world. The effort of depositors to draw out currency by presenting themselves at the wickets of the banks is merely a surface indication of a much deeper-seated trouble. Probably a good while before any such condition arrives, long before the general public becomes aware of a bank's weakness, or fears that an institution is unsound (though it really may not be so), larger depositors have begun to withdraw their funds. As a rule, they will simply have allowed their accounts with the bank to run down, checking them out in payment of obligations and not increasing them. Or, they may have directly transferred their accounts to other banks by drawing checks upon the bank in which they originally kept their accounts.

Runs on Banks Only an Indication of Trouble

In either case, other banks have become the creditors of the bank which is under suspicion to a much greater amount than it can claim from them. That is to say, there is a heavy balance against the bank which it must liquidate in some way. It cannot liquidate this balance by simply paying in its own notes, for these will promptly be sent home for redemption, in which case it will be in exactly the same position as before. All it can do is to secure a rediscount with some other bank which has claims upon the banks that are demanding payment from the first institution. It may thus get the rediscounting bank to relieve it of a part of the claims against it. The bank does this for a consideration and accepts part of the assets of the bank that asks for the discount as a protection.

Or, if all banks are united, they may agree to accept in payment of balances between themselves notes or credits which are obtained from a committee representing the joint institutions and formed for that express purpose. In this case, they merely agree to defer the liquidation of their claims against one another until a future date, being in the meantime protected by portions of bank assets which are segregated and turned over to the representatives of the combined institutions as security.

Issues Protected by an Association of Banks

In all these cases, available funds have been obtained simply by

securing the recognition of certain assets as being undeniably and unmistakably good so that they, or what represents them, are accepted by the community, whether directly or indirectly, in liquidation of the claims held by the community against the particular bank that has been under suspicion. Available funds, in other words, are representatives of value which are so clearly worth their face and are so plainly and immediately collectible that they readily pass current. They may take the form of notes secured by bonds of known character; or they may be the obligations of the bank itself protected by special endorsements; or they may be notes issued by some stronger bank whose credit is above reproach; or they may be simple claims (deposit credits) upon such a bank; or they may be notes or claims which have been recognized and validated by the general group of banks of the community for use among themselves. Whatever they may be, they perform the same function—they serve to show creditors that the bank or banks under suspicion have assets which they are able to dispose of in exchange for evidences of value that are undoubted.

Summary of Ways Assets Create Means of Payment

Causes Behind Note Issues

§4. In the past, much emphasis has been placed on the inelasticity of our note-issues; but to-day it is coming to be understood that the underlying trouble in a time of stringency is the inelasticity of our credit system. Already it has been shown how our rigid percentage of reserves to liabilities creates a dangerous situation.

Some persons have a belief that monetary and credit emergencies can be met by the issue of banknotes. Others express the belief that the problem is not so much one of circulation as it is one of the organization of credit. The problems, therefore, seem to center about banknotes on the one hand, and the power of a bank to lend on the other: (1) The needs of the public for currency, and (2) the needs of a bank when under pressure in meeting demands for loans.

The needs of the public for currency to act as a medium of exchange in buying and selling goods, in paying wage-rolls, in travel, etc., are obvious. In certain sorts of transactions, mainly in retail trade and in districts unused to banking methods, some form of money must be passed from buyer to seller. In total amounts, however, these transactions are insignificant in comparison with those transactions on a large scale which are carried

on by checks, drafts or bills of exchange—without the use of any forms of ordinary money. With an increasing population, but chiefly with the increasing products bought and sold at retail, the demand for currency, such as it is, must normally increase absolutely in greater or less sums. For such needs an elastic banknote circulation, slowly rising, but expanding and contracting sharply with seasonal demands, is imperative. Our present national bank circulation does not provide for this elasticity. It expands and contracts without any direct relation to the demands of the community. To this point of elasticity much emphasis has been directed. Its importance is not to be minimized; but it is to be doubted if it is as vital as some suppose. If we used only banknotes (or other paper money) as a medium of exchange, the insistence upon an elastic banknote circulation would be of first importance; and in the limited field in which actual money is imperative, the need of an elastic banknote issue to the general public remains highly important. Although we have the deposit currency as a medium of exchange which is perfectly elastic, elasticity of note issues should receive attention in the due proportion of the importance of banknotes to other media of exchange, under normal conditions of business.

Certain Elasticity of Notes Imperative

Still keeping in mind, however, the needs of the public for a medium of exchange and not the needs of the bank itself, it will probably appear to many that the demand of the public for expanding issues of currency is of vital importance in a time of financial distress, such as that in the autumn of 1907. To those who set most store by the virtues of an elastic banknote issue this seems the crux of the whole matter. It is supposed that in a time of stringency the public will demand more circulation; and to support this view the events of the panic of 1907 have been drawn upon as proof. It is true, of course, that government or bank notes could not be had in most cities during the height of the panic in 1907, even in small sums; and as a consequence the clearing-house associations issued clearing-house notes (as distinct from clearing-house loan certificates) for circulation among the public. Without doubt this inability to get cash for a small check on a bank or at a paying office made a deeper impression on the minds of the people than any other event during the panic. It was this popular belief in the need of more money to which Congress evidently catered when it passed the Aldrich-Vreeland Act, as a provisional measure before a

An Illustration From 1907

coming election in 1908. It was, as everyone must admit, a striking commentary on the inadequacy of our banking and monetary system that it was impossible for the banks to supply to employers of labor and for the small needs of every day a relatively small amount of currency having a general circulation. Yet, on the other hand, it is a fact that the total amounts of the clearing-house notes for the use of the public were not large, nor were they long outstanding. Moreover, as affecting the ability of the producing and trading firms to weather the stress of the panic, they had practically no influence whatever. The banks were more frightened than the public. The demands of the small local banks for additional precautionary reserves drew down the cash reserves of city banks more than did the demands of business men. This was the reason for the scarcity of circulation. The holding on to their cash by the city banks was primarily in the interest of reserves and, therefore, in the interest of those who wished loans or who had to be carried for a time.

Popular Idea of Need of Notes In Panic

The power to expand their note issues (which are liabilities) could not have added to the cash reserves of the banks and thus have enlarged their power to aid needy borrowers. It is true, however, that an expansion of note issues would have aided the banks indirectly; it would have allowed them to satisfy the urgent demand of the public for a medium of exchange by passing out their notes and thus would have enabled them to retain lawful money which could be used as reserves to support their loans and deposits. But, primarily, the issue of banknotes is for circulation in the hands of the public and not for any serious advantage which they render in increasing the power of the banks to lend and to stave off a panic. Accordingly, the prevailing idea that we must provide against future panics and avoid a repetition of what happened in the panic of 1907 by arranging for the rapid issue of banknotes in a time of emergency is quite aside from the real point, for it is based on the wrong assumption that it is the lack of currency in the hands of the public, and not the difficulty of the banks in lending, which is the critical thing at such a time.

Banknotes not Reserve Money

This popular insistence on the view that we can prevent the occurrence of panics and meet all the dangers of a financial panic, once it is upon us, by the device of an expansion of banknotes is based on an erroneous analysis of banking operations in times of stress. Very respectable authorities have asserted that our mone-

tary system is radically at fault so long as it will not prevent the occurrence of panics. And the belief that the Bank of England and the Bank of France—as central institutions—have been able to head off speculation and avert the evils of expanded credit is referred to as an instance of what can be done by a central institution in this country. We have been led to think that the issue of notes is the means by which the effects of the crisis are met and its inconveniences reduced; in the case of England by the suspension of the Bank Act bringing out more notes from the Issue Department; and in the case of France directly by the increase of notes of the Bank of France. As we shall see later, this appeal to the banks of England and France is wholly unfounded in fact.

Panics not Prevented Merely by Notes in Europe

The reserve city bank which can quickly increase its own notes can supply the demands made upon it by country national banks and correspondents—provided the country bank wishes only currency for circulation in its neighborhood and not for its own reserves. Here, again, the new bank issues do not give the pivotal aid which some suppose always comes from additional circulation. Not being lawful money, they could not be used in reserves and, therefore, would not—and could not—improve the lending power of the local country national bank. They would, however, supply currency to the country bank which could be paid out, if urgently demanded, and thus indirectly protect reserves, and they could be used as reserves by other than national banks.

Help to Country Banks

Another advantage in emergency banknotes, of course, is the opportunity they present to national banks having relations with state banks and trust companies. By issuing their own notes they may exchange them for lawful money held by banks outside the national system. In this way they can indirectly increase their lawful money and consequently their power to lend.

All the above advantages are patent and are arguments in favor of a margin of elastic note issues. But while these issues have a great importance, they would not cure the fundamental difficulties existing in times of panic. The principal reason for this statement exists in the fact that, obviously, the national bank cannot replenish its reserves—which are an asset—by an addition to its own notes, which are a liability. Apart from its illegality, it is a banking lie.

Banknotes not an Asset

Too much may be made of the need of an elastic bank circulation in a time of panic in view of the fact that we already have a

perfectly elastic medium of exchange in our deposit currency, especially for all large transactions. The term "money" is loosely used. We use gold as a standard, but we do not use it to any appreciable extent as a medium of exchange. More than 95 per cent of our large transactions are performed by a check and deposit currency which rises and falls exactly in proportion to the exchanges of goods which call forth loans and bank deposits. Under existing familiar methods of payment by checks and drafts, the borrower who is able to get a loan in a time of stress has no difficulty whatever in meeting his maturing obligation by a check on a solvent bank. To get the loan is the important thing—not the particular form of liability which the bank gives him on making the discount. In fact, on getting the loan the borrowing merchant would not wish to take out notes and then be obliged to find a place in which to deposit them again. It is clear, therefore, that the mere power to issue banknotes in itself is not the only nor the most important way of meeting an emergency brought on by a disturbance of credit.

Deposit Currency Sufficient as Medium of Exchange in Panic

We have heard much in this country about the need of an elastic bank currency. About a marginal elasticity to a large total circulation in normal conditions for seasonal demands, something has already been said. There is no difference of opinion concerning that important need. But most persons who advocate an elastic currency have in mind a need of a very different kind—the need of help to borrowers in a time of panic. For a need of this kind careful examination will disclose that the issue of banknotes is of minor importance and does not touch the real cause of difficulty. One says of minor importance, for the ability to pay off depositors in banknotes would undoubtedly give to customers of a bank the means of meeting maturing indebtedness. But the serious pressure comes from those whose deposit accounts are insufficient to meet heavy panic demands. The real question is: Will the power to issue more notes (a liability) enable a bank to enlarge its loans greatly without having thereby received anything which will increase its cash reserves?

Bank-Notes of Minor Importance

It is a crude thought that an increase of banknotes is needed by the general public as a medium of exchange because of the inability of business men to exchange goods due to a scarcity of currency. The real difficulty resides not with the general public and the media of exchange—for checks are as good as ever as a medium of exchange if there are deposit accounts on which they can be

drawn—but it resides with the banks, with the power of the banks to expand their loans in a time of stress. This is the pivotal thing in any plan to relieve the distress of a financial panic (even with those who are urging an elastic currency as a cure-all).

§5. So much for the relation of bank issues to the situation created by a financial crisis; but, as has been already pointed out, there are other elements in the situation of far greater importance. When we look back to the panic of 1907 we find three important happenings, connected in purpose and need, which altogether transcend the minor question of the issue of clearing-house currency for public use. These three points of central importance have to do with the lending power of the banks and are as follows: (1) The importation of gold; (2) The deposit of lawful money with the banks by the Treasury; (3) The issue of clearing-house loan certificates.

Lending Power of Bank Most Important

Every banker, every borrower, who was concerned with the work of preventing disaster from spreading in 1907 knows how dominating were these three matters. Why? Because they directly touched the power of the banks to lend. There was a crisis, not because of a scarcity of a medium of exchange in the hands of the public, but because large banks had had excessive demands made upon them for loans and because they held paper which had become more or less unsound. A crisis comes because credit has been unduly expanded in a period of prolonged prosperity; in an optimistic spirit men have entered into transactions beyond their actual means, as is shown when the test of actual payment is exacted, and in a time of fright, collateral, as well as goods, falls in price. In such a situation liquidation needs time if disaster is to be prevented. Houses doing a legitimate business are in trouble, and the banks are called upon to carry them. Just when timid persons or country banks are drawing down cash reserves, the banks are forced by the situation to increase their loans. In the one week ending November 2, 1907, the reserves of the New York banks fell $37,000,000, while loans were increased $60,000,000. That showed that the New York banks met a difficult situation with courage and good judgment. At their own risk they came to the rescue of a hard-pressed business public. Everything centered in those things which would aid the lending power of the banks. It is needless to say that the issue by the bank of its own liabilities in the form of notes

Why a Crisis Arises

would be an insignificant palliative and would not touch (except as mentioned above) the cash reserves and the power to lend. *The one central thing to be done was to increase reserves.* Here is the crux of the whole matter, whether it is a time of an impending stringency or the storm-center of a crushing panic. The bank's own notes (its own liability) cannot legally or morally be used to fill up its reserves (the bank's active asset). Here is the fatal deficiency of banknote issues as a means of curing a panic. The one thing needed was lawful money which could be used as reserves.

Fatal Deficiency of Note Issues

The most important of the devices resorted to in 1907, however, as well as in former panics as far back as 1861, was the issue of clearing-house loan certificates. What was the point of their issue? It was not that the country needed more money for general circulation or more media of exchange, but that the banks whose reserves had run down needed aid for the purpose of lending to hard-pressed borrowers. In a crisis what is wanted—and wanted above all other things—is the loan. Once given the loan, the borrower has no difficulty in finding a medium of exchange, by which he can transfer his credit in a way to satisfy his maturing obligation. The loan is the primary thing. All that the creditor demands is a means of payment acceptable in his community. It is just at this point that we find the most confusion of thinking and the greatest amount of loose talking. It is carelessly assumed that the great need is an issue of banknotes, when in reality the great need is some means—whatever it may be—which will enable a bank to make loans to a client, who can thereby be saved from failure and from hasty and ruinous liquidation. The whole object of clearing-house certificates, then, is—not to provide currency—but to make loans possible to solvent, though needy, borrowers. After loans are made, checks provide all the means of payment anyone needs. The increase of a bank's liabilities does not increase its reserves or its power to lend, so that the issue of banknotes—except as above indicated—is wholly aside from the point.

Clearing House Loan Certificates

§6. The real remedy for panic conditions is thus seen to be not currency but the creation of a means of payment in which all have confidence. The "confidence" may be supplied through the issue of properly secured currency, but it is the former and not the latter which ameliorates the situation. And it is not desirable that the issue of currency should be the only way of restoring confidence.

On the contrary, it is very much better that means of payment should be supplied in that form which is most convenient to the bank that is drawn upon. For example, if a bank finds itself hard pressed by creditors so that its stock of cash is running very low, and, if nine-tenths of the total demand upon it comes from other banks, while one-tenth comes from outsiders, how shall it be strengthened? Anything that will enable it to satisfy its two classes of creditors will do the work.

Restoration of Confidence

But it is very much better that the obligations it owes to other banks should be liquidated as simply and conveniently as possible. If it can bring about such a liquidation by giving these banks checks upon some larger and stronger institution, the needs of the case are met quite as well as if it handed them bundles of "emergency currency." It could get the credit with the large institution which would enable it to draw in this way only by satisfying that institution that it had good assets and by leaving a part of such assets with the institution as security. If the bank were able to do this, it would need fear nothing, so long as its portfolio contained abundant paper of an assured kind. In this case, then, the banks which got into difficulties with the public could be relieved up to the point that was fixed by their own possession of good assets and by the capacity of the institution to grant them relief by giving them credits on the security of their assets when presented for rediscount.

But suppose that the lack of confidence felt by the public extended to not one, nor to a few, but to many institutions in various parts of the country—could relief be obtained in this same way? Would there not be a limit to what could be done by the institution engaged in the rediscount business? Would not the coming in of much paper practically subject the institution to so severe a strain as to compel it to cease rediscounting, inasmuch as it must see to the security and convertibility of its own outstanding obligations? Of course the answer to such a question must be found only under hypothetical conditions.

Limit to Rediscounts of Good Assets

If there were so general a condition of lack of confidence in the banking system that every creditor at every bank insisted upon having his whole obligation liquidated in cash, no banking system could stand the strain. In such a case, if there were an institution which was engaged in rediscounting paper for any bank that found its resources running low, a time would come when such an institution could no longer extend accommodations because it could not con-

vert all of the obligations of all of the banks into available funds at once. If those asking such conversion did so because of doubt in the solvency of the banking system as a whole, a point would be reached beyond which no further relief could be given, and banknotes, if issued by such a large institution, would for the reasons already indicated be as troublesome as other forms of liability. They would be presented to the institution in liquidation of its own maturing claims on others so that it would be prevented from getting any cash with which to maintain the redeemability of the outstanding claims against it.

Case of General Lack of Confidence

But such a condition could come about only under one or two suppositions: (1) that practically the whole business structure was breaking down, or (2) that the institution which carried on the discounting process was itself crippled by having accepted in the past unsound assets as the basis for its loans. If its assets were all thoroughly sound and it habitually accepted none but unquestionably sound assets, no such point could ever be reached. As for the complete breaking down of the business mechanism—that of course would be a catastrophe that could not be guarded against. The banking mechanism cannot be made stronger than the general body of the business which it is created to facilitate.

§7. The best answer to questions concerning the limit that is likely to be met in providing means to protect the community against demands for liquidation is afforded by a consideration of foreign systems. Examination of these shows that in the principal European countries where there exists a strong institution representing the various banks and largely engaged in rediscounting their paper, disturbances of the kind referred to do not occur. It is customary to say that European banking does not suffer from panics or crises. This, however, would be inaccurate. Investors and financiers in European countries are as likely to make serious errors as those elsewhere. When they do so, the chances that they may involve bankers with them are entirely governed by the prudence and experience of the bankers. Many European private banks are engaged in more or less hazardous enterprises which occasionally break down. European business has its epochs of inflation and contraction due to errors of judgment, miscalculation of securities, etc.

Crises in Europe

But in those countries where an ample means of converting sound assets into immediate funds has been provided, the banking system does not become generally and completely involved. In such

countries it is always possible to convert sound business assets into means of payment. This is practicable simply because institutions exist equipped with sufficient capital to meet all legitimate demands and so rigidly governed by law or custom, or both, as to have been entirely debarred from speculative operations. As their business has consisted entirely or largely in the testing of paper which had already been tested by bankers, rejecting all paper which was based upon or grew out of non-commercial operations, and accepting only that which was the product of the actual buying and selling of goods and the movement of genuinely existing values, these institutions are constantly in position to convert good assets into immediate resources, retaining meanwhile the power to hold the confidence of the commuity by reason of their conservatism and large means. Under such conditions the banking system as a whole is not likely to be troubled by panics or crises except in so far as its members may have accepted paper which was not good, or which was lowered in value by the shrinkage due to the loss of confidence and consequent reduction of prices which accompanies the panic.

Sound Assets Converted Into Means of Payment

These phenomena have nothing to do with the process of facilitating the exchange of goods by regular business transactions; but in the United States the regular and steady business house is involved with the speculator and the undertaker of hazardous enterprises. He suffers from the shrinkage of credit and the suspension of payments in times of panic notwithstanding that he was no factor in bringing them on and that the security he has to offer is as good as it ever was. But because banks have allowed themselves to loan their capital to those who are more venturesome or because loss of public confidence due to the misconduct of a few banks has weakened all, the proprietor of perfectly good paper cannot secure the accommodation he must have, nor can the bank which holds such paper convert it into resources at will.

Business Involved With Speculation

§8. It is thus seen that the essential attribute of soundness which suffices to carry a system through a commercial panic or crisis without disaster is simply that of conservatism and adherence to known values. If all national banks would practice such conservatism in methods of discounting there might be no difficulty, in spite of the possible danger in the fact that many of them are of small capital and may be forced to the wall by a sudden demand, which leaves them no time or opportunity to convert their assets.

But the national banking act does not restrict national banks rigidly to loans upon commercial paper and other absolutely live security. If it did do so, many national banks would be unable to get the business they need in order to continue in existence. They would have to close their doors.

Present Restrictions upon Assets

Moreover, such a limitation would prevent many perfectly legitimate enterprises from getting accommodation. As things stand, too, the national banks must compete with state banks; and even with the present limitation upon the kinds of business in which they may engage they find it a decidedly difficult task in many places to sustain themselves. Under these conditions, it is not possible to limit the national banks much more closely in the kinds of business they do than is attempted by the national banking act.

Some few restrictions in certain directions would be helpful, but in the main it is not feasible to go very much further. The country therefore has to run its chance and when periods of stringency come on, it must rely upon the possibility that a sufficient number of banks have been so conservative in their methods as to possess the means of granting relief to others, or failing in this, that some extraordinary device like the suspension of payments, or the issue of clearing-house loan certificates, will be adopted by common consent as a means of getting time to retreat from the too advanced position assumed by the banks in granting their discount. The remedy for the difficulties of a threatened panic or crisis does not lie in such temporary and sporadic measures, but is to be found in the provision of a regular source of accommodation.

Clearing House Relief Expensive

Every economic expedient which is resorted to sporadically and semi-occasionally is expensive. This is true of the methods employed under the national banking system for the relief of panic. When clearing-house certificates have been issued heretofore they have usually borne an interest of six per cent or more. But this was only a small part of the cost of issuing them. Much greater was the cost involved in the withdrawal of deposits and in the general weakening of the institutions which preceded and forced the issue of the certificates.

In the Aldrich-Vreeland Act of 1908, provision was made for the issue of emergency currency through national currency associations. But these emergency notes were required to pay a tax rising from 5 per cent during the first month of their life to 10 per cent at the end of six months. The cost was so enormous that no

such notes have ever been issued, the expense of issue being one of the prime factors militating against their being taken out.

This idea of a very high rate of charge or tax to be imposed upon the notes that are used for the purpose of relieving a panic or crisis is fundamentally fallacious. As we have already seen, there is little distinction between the notes or certificates, or whatever they may be called, and the granting of accommodation in any other form. And there is no occasion for making the getting of credits in times of commercial difficulty any more expensive than necessary. The argument is all the other way. This extreme costliness of relief in times of panic or pressure has been one of the most serious criticisms upon the national banking system and the burden of it has been keenly felt by borrowers on all such occasions. They have noted that they could get accommodation to any extent when money was easy and business was flourishing—that is to say, when they did not need it. But they have found that, when the relief was actually needed, not only for the sake of given individuals, but for that of the community, and when they themselves stood ready to offer their best assets as security, the aid was not forthcoming, or, if obtained at all, must be paid for at an exorbitant rate. A period of panic or crisis is a period when accommodation should be granted as liberally and as cheaply as possible, and when no artificial and unnecessary obstacles should be put in the way of extending it.

Currency Association Notes too Expensive

High Tax on Loans in Panic Wrong

It remains true nevertheless that increased demand for a given article or service invariably and properly results in a higher price, supply remaining the same. The great European banks raise their rates as the demand for loans stiffens or as supply of specie falls off owing to adverse balances of trade or the hoarding of cash. They do this as a matter of routine business for the purpose of equalizing the supply of loans with the demand for them. They recognize that many applications for loans at banks are not necessary but are matters of convenience or profit. If the bank rate is, say, 4 per cent, many persons will see a profit in the use of borrowed money obtained on that basis. At 5 per cent, a certain number of operations are excluded, because the additional 1 per cent cuts the margin of advantage. As the rate rises, the number of applications decreases and the institution is more fully able to meet the claims for accommodation which are presented to it.

Rate of Discount Equalizes Supply and Demand for Loans

But this is a phenomenon which is not characteristic of periods of panic or stringency; it is seen on every occasion when a readjustment of supply and demand for bank accommodation is

needed. If, in a crisis, this demand for accommodation becomes exceptionally great, while reserves fall off, an unusual increase in the rate of discount may be desirable for the purpose of warning all those who do not absolutely require accommodation that they had better not apply for it and that, if they do, they will be charged a rate which they cannot afford. This very process of raising the rate and thus regulating the supply of, and demand for, bank accommodation is one of the most important factors in preventing the commercial world from drifting into a panic or crisis. In the United States, we have had no means of securing such an advance in rates of discount by general agreement or consent among the banks. The banks have been competing sharply with one another, and, in their effort to get business, have allowed rates to become and remain unduly low until the community was so far advanced toward a stringency that it was too late to apply the precautionary method of raising the rate of discount, and have it serve any useful purpose.

Increase of Rate as a Preventive to Expansion

If there were some mechanism, like a National Reserve Association, to which resort was currently had for rediscounts, and which would act as the principal reserve-holding agency of the country, it would be possible to compare the reserve more accurately than now with the total demands likely to fall upon it, while it would be possible to protect this reserve as is done in Europe by regulation of the "bank rate." The function which is performed in thus shifting the rate is merely that of equalizing demand and supply. It is not the purpose to penalize the man who needs loans, nor is it that of "driving in" the notes or other forms of accommodation that are received by the borrower. These forms of bank credit will take care of themselves if their issue is made dependent solely upon commercial demand and sufficient opportunities are provided for their immediate redemption.

Need of a Guiding Agency in United States to Fix Rate

§9. Thus far the assumption in what has been said has been that a given country at any time was practically dependent upon its own stock of specie and currency for the redemption of its bank liabilities into current funds. The discussion has proceeded from the assumption that the service of the bank was that of economizing and equalizing such funds, preventing them from being dissipated, and using them in such a way as to take off all of those demands for specie and notes that were simply due to a lack of confidence in the ability to pay. This is the normal duty of the bank.

But conditions may supervene in which it is desirable to strengthen the stock of specie by getting more from abroad. In ordinary times, the international distribution of the precious metals is self-regulating and adjusts itself in accordance with the supply of, and demand for, metal in the different countries of the world. This is brought about by international payments for goods and services. In time of panic or crisis, there may arise a sudden sharp demand for money which has no relation to the necessities of exchange and is simply due to a disturbance of the level of business confidence such as we have already sketched. In such instances, it is not possible to wait for the international distribution of the precious metals to adjust itself by the sure but slow forces which ordinarily govern it. It may then be desirable or necessary to import specie or gold from abroad. The object of such importation is of course that of building up bank reserves and thereby rendering it possible to extend more credit if desired.

International Movement of Precious Metals

In foreign countries where the rate of discount is controlled by some large institution which acts as the reserve-holder of all the banks, this matter of importation is attended to by that institution. Gold is engaged abroad when it is needed in order to build up a specie reserve in this country. In such cases it will be borrowed, usually from those who have it. That is to say, foreign bankers will be asked to ship a part of their reserve money to this country. The loan or advance may be protected, just as in the case of a loan to an individual, by collateral security of some kind. Or, where a great staple crop like cotton is soon to move abroad, the shipment of gold may be obtained as an advance payment on cotton bills.

In such instances, however, the real nature of the transaction is merely that of a loan. The relief obtained from it is again merely that of convincing the home public that there are resources in actual cash that are amply able to take care of all outstanding demand liabilities. Such operations are expensive. In the United States they are not usually undertaken until the decline of bank reserves has reached a decidedly alarming point; but it is very desirable that this method of restoring a reserve, if it is to be resorted to at all, should be employed early enough to get its full benefit. The best banking theory, therefore, tends to penalize banks for permitting their reserves to become too low by taxing them in proportion as their reserves fall below a given point. Of course this means that the bank shifts the cost of the tax to the borrower who insists upon

Importation of Gold Expensive

Tax Banks as Reserves Fall

further accommodation after the reserve has gone down to the point specified. But it also means that the bank will as promptly as possible resort to the importation of gold whenever that becomes cheaper than the payment of the tax. This will be done both in its own interest and in that of the borrower.

CHAPTER V

COMMERCIAL PAPER

1. Classification of Loans—2. Nature and Origin of Commercial Paper—3. Types of Commercial Paper—4. Characteristics of Commercial Paper—5. Reserve Association Restricted to Commercial Paper—6. American Practice With Promissory Notes—7. Commercial Paper a Protection Against Over-Expansion.

§ 1. The character of the bank in its relation to the community, like that of every other institution, is determined by the kind of business that it does. However, it is not ordinarily recognized by the public that there is great diversity in kinds of business done with banks, and that there is no uniform character common to all of them. Some banks do a certain kind of business based on given classes of transactions almost exclusively. Others confine themselves largely to a particular kind of paper, and still others do several different classes of business, carrying them along side by side. In general, the character of the institution and the kind of work that it does are necessarily determined by its clientèle and the demands that are made upon it. This clientèle may be fairly uniform or homogeneous, or it may consist of persons engaged in many very different classes of trade who ask the bank's assistance in financing the operations they are engaged in, and who, therefore, lead it into varying lines of enterprise in so far as it undertakes to sustain these different persons, by supplying them with funds.

Business With Banks Varies

The general business done by banks of whatever kind is that of lending. They may, therefore, be classified upon the basis of the kinds of loans they make. This classification may take a two-fold form: It may be founded (a) upon the character of the security offered to protect the loan; or (b) the time for which the loan is obtained and the form in which the obligation of the borrower to the bank is recognized.

The Security for Loans

From the viewpoint of security, three general groupings may be noted. Loans may be protected (1) by collateral security, in which case a claim is given the bank upon stocks, bonds, mortgages, or some

other evidence of tangible invested values; or (2) they may be "unsecured," in which case the bank simply receives a note from an individual, promising to pay a specified sum at a specified time, protection being found in high standing and in the possession of general property by the borrower; or (3) they may be based upon evidence of a commercial transaction which is to be liquidated at some time in the future. In this latter case, the ultimate protection to the bank is found in the fact that borrowers are possessed of property, while the prospect of immediate payment is improved by the fact that, by the nature of the security he has offered, the borrower is shown to have had dealings which will result in giving him liquid funds at a date in the early future.

Time Distinctions

From the viewpoint of time, the chief lines of classification should be drawn between those loans which are made on demand, or on call, and those which are made on time, the latter being grouped as short-time and long-time loans. The loans made on call correspond roughly to those of the first classification by security—the collateral loans—while those made on time correspond to the other two classes of loans under the first grouping—those protected by personal credit and those by evidences of the transactions. Long-time loans are usually protected by a mortgage or other claim upon property, and are not to be considered as banking loans in the proper sense of the term.

Commercial Paper

The bulk of banking business growing out of commerce and industry is confined to loans on personal credit, or loans based on evidences of transactions; the paper which develops in the course of this business and is held by the banks is known as commercial paper. It consists of instruments evidencing claims upon individuals, stated in terms of money, and resulting from operations requiring a comparatively short period for their consummation. When a man desires funds for a long period, he should get them, not from the bank, but from those who have spare capital to invest for some considerable period of time. The business of the bank, then, consists of dealing in the commercial paper which grows out of current transactions.

§ 2. We have already classified commercial paper on a rough general basis. It is now necessary to consider more carefully the nature of this paper and the way in which it comes into exist-

ence, as well as the relation of the bank to it. Suppose that A, who is doing a large business, has sold goods on credit (open accounts) to many customers. A may find himself short of current funds, in consequence of the absorption of his capital in carrying these customers. If he goes to the bank for accommodation, he may request a loan simply on the strength of his own personal, unsecured note. In this case, the wisdom of the bank in granting the loan will depend entirely upon what it knows of the customer. If the total amount which he desires is moderate as compared with his total assets, and particularly as compared with his current cash receipts over a specified period, the loan is "safe." If it complies wholly with these requirements, it is, perhaps, the safest purchase the bank can make, since the individual has total assets largely in excess of the loan, while he has current incomes that supply the means for prompt payment. The bank can assure itself that these conditions are complied with only by a thorough knowledge of the business condition of the concern or person obtaining the loan. It may get this either through a statement of the business itself, if entire confidence is entertained concerning the honesty and accuracy of its accounting system, or it may get it through the work of an outside firm of accountants who are called in to examine the books and certify to the truthfulness of the showing made and to its correctness from an economic standpoint. Thus assured, the bank is warranted in advancing the funds that are needed. If it does so, accepting in exchange the unsecured note of the borrower, the paper thus obtained is termed single-name paper.

Single Name Paper

According to the Comptroller of the Currency, there was held by national banks the country over (7,301 in all in 1911) the following amounts of various classes of paper during the past three years:[1]

Statistics of Paper Held by National Banks

Class.	1909 Amt. Millions	1909 %	1910 Amt.	1910 %	1911 Amt.	1911 %
On demand, paper with one or more individual or firm names	$ 441	8.6	$ 524	9.6	$ 529	9.4
On demand, secured by stocks, bonds and other personal securities	957	18.7	939	17.2	953	17.0
On time, paper with two or more individual or firm names	1,698	33.2	1,842	33.7	1,885	33.6
On time, single-name paper (one person or firm), without other security	971	18.9	1,068	19.5	1,124	20.0
On time, secured by stocks, bonds and other personal securities, or on mortgages or other real estate security	1,060	20.6	1,092	20.0	1,117	20.0
Total	$5,128	100.0	$5,467	100.0	$5,610	100.0

[1]Report of Comptroller of the Currency, 1911, p. 9.

It will be observed that about one-third of the total paper held by the banks was two-name paper on time, and about one-fifth was single-name paper on time. These made a total of a little more than one-half for the two kinds of loans taken together. Demand paper with one or more names furnished about 9 per cent more.

§ 3. Suppose, however, that A, instead of selling his goods on credit (open accounts), has required his customers to give him their notes payable at 30 days. He may take these notes to his bank and ask for a discount, in which case the bank will desire to know substantially the same things as before. It may or may not make a close inquiry into the condition of the persons who gave the notes to the merchant that originally sold the goods. It assumes, of course, that A has investigated them with care. But its real security is found in the fact that it knows the man who presents the notes for discount, is familiar with his business, and requires him to endorse the notes before getting accommodation based on them. This is called two-name paper, and while collection at maturity will first be sought from the person who made the notes—that is, the person who bought the goods from the original merchant and gave the latter the notes in exchange—the bank will, if payment is not promptly made, require the person who secured the discount to make good the sum.

Creation of Two-Name Paper

The value of two-name paper as compared with single-name paper is entirely relative and dependent upon circumstances. If the individual who presents the notes for discount is stronger and better known financially than the makers of the notes, it is probable that his own unsecured note would be quite as satisfactory as the two-name paper. If the maker of the notes and the man who presents them for discount are both persons of small resources and questionable credit, the combination of liability furnished by the two-name paper is not important and does not of itself make the paper good. The ultimate test is invariably found in the responsibility of those whose names appear, and if one of these names represents unquestioned commercial solvency, it is far better as a protection to the bank than several names whose credit is doubtful or limited.

Test of Two-Name Paper

The amount of various classes of paper carried by national banks in New York City is thus stated by the Comptroller:[1]

[1] *Ibid.*, p. 10.

Loans and Discounts.	Aug. 22, 1907 38 Banks Millions	Sept. 23, 1908 37 Banks	Sept. 1, 1909 38 Banks	Sept. 1, 1910 39 Banks	June 7, 1911 40 Banks
On demand, paper with one or more individual or firm names...	$ 16	$ 6	$ 7	$ 9	$ 9
On demand, secured by stocks, bonds and other personal securities	251	374	385	328	331
On time, paper with two or more individual or firm names...	161	146	145	176	177
On time, single-name paper (one person or firm), without other securities	130	132	163	170	197
On time, secured by stocks, bonds and other personal securities, or on real estate mortgages or other liens on realty.....	152	245	223	188	188
Total	$712	$905	$925	$873	$903

Paper Held by New York Banks

It will be observed from the figures for the last report that in all about $375,000,000 of single and double name paper was carried by the New York banks, and that this was fairly evenly divided between the two classes, the preference being slightly for the single-name paper. The amount of either class of security is usually very much less than the volume of the loans made on demand and secured by stocks, bonds, etc.

Contrast Between New York and Country as Whole

That is, loans protected by stocks, etc., on demand amounted to about 36 per cent of the whole; and collateral loans, on time and on demand, amounted to about 56 per cent. This furnishes a striking contrast with the showing for the national banks as a whole and indicates that the larger bulk of the commercial paper of the country originates in the producing districts and in the commercial centers; while financial operations, which predominate in New York, are financed very largely on the call-loan basis. (See Chapter VII on Call Loans.) The commercial paper of the country, whether single-name or two-name, whether on time or on demand (usually the former), constitutes the staple bankable security of the country and represents the demands of the business interests proper upon the banks.

Drafts Drawn on Buyers

The kind of two-name paper which has just been described is not the only one. In many parts of the country, it is not even the most important. A, who sold the goods to B, may instead of requiring B to give him a "note" payable after 30 days, stipulate at the time when his sale is made, that he will simply "draw" on B "at 30 days' sight." That is to say, simultaneously with his shipment of goods to B, he hands to his bank a draft on B which

is payable 30 days after being presented to the latter. The bank then sends this draft to a bank in the place where B is situated, and this bank presents it to B, who, if the transaction is carried out, "accepts" the draft by writing his name, with the date, upon it under the word "accepted." This makes the draft an obligation on the part of B to pay a specified sum at the end of a specified time. It is primarily an obligation of B's, but in case he should not pay it, any person who had acquired A's claim on B in the meantime, would look to A for payment.

Now, if A merely passed the draft to his bank for collection, he must wait 30 days in order to get his payment, which is then reported to him and placed to his credit by the bank that originally took the draft. Probably, however, A wants funds at once. If so, he has told his bank at the outset that he wishes to have the draft discounted. In that case, the bank has allowed him an immediate credit on its books equal to the face of the draft less discount. It then looks to B for payment, thereby standing in the place of A. But in the event that B defaults and does not liquidate at the specified time, A's bank will look to A, the merchant, for reimbursement of the amount which it originally advanced him on the strength of his application for a discount accompanied by the draft on B. It is, in short, protected by two names. Paper of this kind is regarded with peculiar favor by banks, because it grows out of a live commercial transaction; and, where the operation is legitimate, there is every reason to suppose that B will liquidate at maturity, while in case he does not, the bank can fall back upon an individual in its own city about whom it has full information. It may make the discount with confidence, if it is absolutely assured of the solvency and honesty of either A or B, the transaction itself being good evidence that there is real value in existence to back up the transaction.

Based on Exchange of Goods

If the bank wishes to be exceedingly well protected, it may demand that A, who discounts the draft with it, shall turn over to it, along with the draft itself, the documents which give control of the property which has been sold, so long as the same is in transit. These documents may be of several kinds and more or less numerous. The commonest is the ordinary "bill of lading," issued by the common carrier who has accepted the goods. It indicates that the ultimate power of demanding the goods from the carrier has been surrendered by the shipper, and is now in

Paper Accompanied by Bills of Lading

the hands of the bank which has discounted the draft. The bank may send this bill of lading, along with the draft, to its correspondent bank in the place where B lives, and may decline to give up the title to the property until such time as B liquidates the draft. Or, it may assent to the surrender of the property under conditions which are satisfactory to itself. In this case, the use of the documents serves to locate the responsibility for releasing the ultimate property on which the transaction is based—the goods that passed from A to B in the original transaction.

Besides the bill of lading thus referred to, there may be certificates of insurance, and in the case of foreign shipments, master's receipts, the proper consular invoices, health certificates in the case of foodstuffs, etc., etc. The aim in transferring these documents is to show that all the requirements of a bona fide sale have been complied with, and that the way has been completely cleared for putting the goods en route to the consumer via the ultimate dealer, while all risks in connection with the process have been transferred to others who are prepared to assume such risks. This is a way of giving the bank additional assurance that everything is right, and that it has nothing to apprehend from legal or other obstacles. It then assumes only the legitimate risks which it was organized to incur—those connected with the transfer of property from man to man, and the collection of the proceeds of sales, either at sight or after the lapse of a specified period.

Other Documents to Avoid Risk

§ 4. We have thus sketched some of the principal types of commercial paper, and are now prepared to understand the characteristics of such paper. It is called "commercial" because it has to do with the operations of trade and commerce and arises out of bona fide transactions. The real and ultimate basis of the operation in such cases is found in the fact that there was a commercial or industrial operation which gave rise to the demand for a loan or accommodation at the bank. This security, taken in the aggregate, is in reality simply the security afforded by the buying power of the population and the general condition of trade and industry as a whole. It is not a kind of security which is dependent upon investment values or earning power in the last analysis, but is a security which is dependent upon consuming power. It is thus directly based upon the capacity of the population to absorb, and pay for, a definite amount of goods which are the products of past operations that have resulted in producing

Commercial Paper Based on Power to Buy

them. This shows clearly how paper of the class referred to is differentiated from other kinds of security, such as collateral of various descriptions.

When call loans are made there is no assurance that the person who makes the loan will be in better position to liquidate his obligation at the end of the time for which it was made than he was at the beginning of the loan period. If he has borrowed for the purpose of carrying on speculative operations, and if his means are quite fully "tied up" in such operations, success in his speculation is necessary, for otherwise the bank will have to look to a sale of the collateral for its payment. While this may be safe enough in any one case, *a general attempt to realize on collateral means that the collateral cannot be sold;* in other words, that there is no immediate means of payment available. This is the most important distinction between loans based on commercial paper and others which are not so based. The commercial paper represents the quick type of loan easily realizable, practically certain to be paid, taking large masses and not individual pieces of paper, and therefore entirely different from the investment securities which are longer in duration and which depend upon future earning power for their value.

Contrast With Call Loans on Collateral

Reserve Association Restricted to Commercial Paper

§ 5. It is with these facts in mind that the proposed plan for a Reserve Association would limit that association largely to transactions based on commercial paper. The Monetary Commission's bill, which presents a Reserve Association plan, defines the kind of operations which the concern may undertake as follows:

> SEC. 26. The National Reserve Association may, through a branch rediscount, for and with the indorsement of any bank having a deposit with it, notes and bills of exchange arising out of commercial transactions; that is, notes and bills of exchange issued or drawn for agricultural, industrial or commercial purposes, and not including notes or bills issued or drawn for the purpose of carrying stocks, bonds, or other investment securities.
>
> Such notes and bills must have a maturity of not more than twenty-eight days, and must have been made at least thirty days prior to the date of rediscount. The amount so rediscounted shall at no time exceed the capital of the bank for which the rediscounts are made. The aggregate of such notes and bills bearing the signature or indorsement of any one person, company, firm or corporation, rediscounted for any one bank, shall at no time exceed ten per centum of the unimpaired capital and surplus of said bank.
>
> SEC. 27. The National Reserve Association may, through a

branch, also rediscount, for and with the indorsement of any bank having a deposit with it, notes and bills of exchange arising out of commercial transactions as hereinbefore defined, having more than twenty-eight days, but not exceeding four months, to run, but in such cases the paper must be guaranteed by the local association of which the bank asking for the rediscount is a member.

An interpretation of these permitted types of transaction, in the light of what has already been said, shows that the functions of the Association would be chiefly confined to operations based on such commercial paper as has been described here. In what we have said, however, no reference has been made to bank acceptances. Because dealings in such acceptances constitute a new type of business, not heretofore practiced in the United States upon the European basis, a special treatment has been given to them. (See Chapter VI on Acceptances.) It will be noted that the rediscounts of the Reserve Association are to be primarily "notes and bills of exchange arising out of commercial transactions," running 28 days or less. Such notes and bills are those issued or drawn for agricultural, industrial or commercial purposes. An exception is made in favor of similar notes and bills of exchange running more than 28 days, but not over four months, provided that such paper is guaranteed by the local association of banks to which any bank asking for the accommodation may belong. This merely means that the Reserve Association, while seeking to limit itself to the very shortest kinds of commercial paper, will stand ready to accept those which run somewhat longer, provided they are of absolutely known goodness—so much so that a group of banks representing a distinct section of the country is willing to guarantee them.

Rediscounted Paper Must Have Been Tested by Banks

It will have been noted that the Reserve Association in rediscounting paper is authorized to deal only with banks which are stockholders in it. This means that the commercial paper which comes to it must be that which has already been tested and approved by the local banks that present it for rediscount. The local banks, of course, are far more familiar with the character of the paper in their own districts or places than any outside institution, however well officered and managed, could be. This means that the transactions that give rise to the paper will have been scrutinized with care by persons technically familiar with local conditions before such paper comes to the Reserve Association to be rediscounted.

Prime Commercial Paper

In the case of the two-name paper already described, which constitutes the bulk of the security of a commercial sort offered to banks, there will thus be, not only the protection afforded by the signatures of the drawer and acceptor of the paper, but also that furnished by the fact that the bank itself has indorsed the paper when applying for a rediscount. Of course, in many places there will be prime commercial paper of the best description, which the bank itself will have recognized as absolutely unquestionable, even though protected by only a single name, but which it has taken up on account of the undoubted solvency and ability of its maker. Such paper will go to the Reserve Association for discount, protected by the maker's name and the indorsement of the bank that originally extended the accommodation to the borrower. It will thus be two-name paper in so far as the Reserve Association itself is concerned. The only condition will be that the loan must have been originally intended for agricultural, industrial or commercial purposes—a group of objects which in this discussion we have classed together under the single head, "Commercial."

Transaction In Goods Often not Shown by Good Paper

§ 6. As is well known, promissory notes make up the bankable paper of this country, as contrasted with the accepted bill of exchange drawn by the seller on the buyer of goods in Europe. The promissory note, however, does not always show the nature of the transaction which gave rise to it. Much reliance, therefore, must be placed on the honor and character of the borrower. One-name paper, not disclosing the exact nature of the use to which it is put, demands strict surveillance and discrimination on the part of the bank. Consequently, it is now not so easy in this country to say what is commercial paper; that is, to affirm that it is the outcome of a direct exchange of goods.

In the Aldrich-Vreeland Act of May 30, 1908, commercial paper was defined as follows:

> "The term 'commercial paper' shall be held to include only notes representing actual commercial transactions, which, when accepted by the Association, shall bear the names of at least two responsible parties and have not exceeding four months to run."

Practically the only way in which two-name paper, based on actual transactions, is presented for discount in this country, is that in which so-called "trade-paper" is created. When a merchant buys goods in the United States on time, he receives a greater or less discount for paying cash before the account is due. This dis-

count varies in different trades. In groceries, food products, etc., the sales are usually on 10 days' time, and the discounts play no real part. In the sale of luxuries, such as fine millinery, or jewelry, the period allowed for payment of goods may be six months. But in trades like hardware, the time runs from 30 to 90 days. Hence, if a discount of 3 per cent is allowed by the seller, if cash is paid in 10 days on goods sold at 90 days' credit, that is equivalent to 3 per cent for 80 days, or at a rate of 13½ per cent per annum. Likewise, a discount of 2 per cent for cash paid in 30 days is equal to 12 per cent per annum. Now, if the buyer has good standing, he can borrow at 4 or 5 per cent, and pay off his account, thereby saving the difference between 4 or 5 and 12 or 13½ per cent. The longer the time on which goods are sold, the larger the discounts and the greater the inducement to borrow and to anticipate payment of the account. Consequently, the merchants having the best credit never wait until their accounts mature; some of poorer credit meet payment at maturity; and others, not able to pay when the accounts fall due, must borrow and meet one indebtedness by creating a new one. Now, this last class, the poorest of all, creates two-name paper, based on actual transactions, on less than four months' time usually, and would be technically acceptable under existing law (May 30, 1908) as "commercial paper" security for note-issues; while the paper of the men of higher credit, who can always borrow and save on the trade discounts, would not be acceptable. It is obvious that this requirement would rule out some of the best paper now held by banks.

Taking Advantage of Trade Discounts

Consequently, the best paper brought to the banks is one-name paper, in the form of a promissory note, which does not show on its face that it is "commercial paper," or paper arising out of a purchase or sale of goods. On the other hand, the buyer of goods whose credit is less good, and who cannot borrow so easily, is the one whose paper may be strictly "commercial," but it is not regarded by the banks nearly as highly as one-name promissory notes of a firm of high standing. Such a buyer cannot pay cash for his goods, because his credit is not high. Therefore, in our practice, it must be remembered that often paper directly based on the exchange of goods may be less desirable because of the standing of the borrower. Thus, in the United States, under existing customs, we have the paradox of one-name paper not technically "commercial," rating higher than some strictly commercial paper. The ultimate reason for this, of course, is that the high credit of

Strictly Commercial Paper Often not the Best

some one-name paper is the conviction of the bank that the borrower's business is legitimate and really of a character to allow of quick liquidation when required. The exception proves the rule. The test of commercial paper may not always lie on the face of the paper. In case of accepted bills of exchange the test is almost always openly to be seen.

Test not Always Easy

In truth, the paper of a firm of high standing readily taken by the bank may not be always "commercial," and hence not always the safest. In case such a firm borrowed on its one-name paper $500,000, and used it to enlarge its plant, the transaction does not provide for its certain and quick liquidation; the paper then tends to belong to the class based on long-term investment securities, and loses its characteristic as commercial paper. Consequently, while arising out of "industrial purposes," and not used for the "carrying of stocks, bonds, or other investment securities," such paper could not be strictly called "commercial paper" available for rediscount at the National Reserve Association. In a time of crisis, such paper would not liquidate itself by the sale of the goods. In fact, much must in the last analysis depend on the management of the bank.

As everyone knows, the banks dealing mainly in loans of a mercantile character are large buyers of paper sold by note brokers. Such notes are rarely secured by collateral, and usually bear one name. In the case of large corporations, the indorsement of more than one officer of the company could not make two-name paper. In spite of some faults in such loans—doubtless remediable—the extent of the dependence on note brokers is widespread. The situation is well expressed by a prominent banker, as follows:

> "The ease with which loans are obtainable in normal times by responsible houses on their own direct, unsecured obligations, through the agency of note brokers, has nearly done away with trade paper (i. e., two-name commercial paper) of the highest grade. All good concerns and many even in second and third grade credit are enabled to borrow all the funds required to take advantage of trade discounts, and enough more to meet all other bills at maturity, so there is little or no reason to settle trade accounts by notes. . . . No house can habitually do so without ultimate damage to its credit. The business of the note broker in directly supplying capital when needed by solvent borrowers for production use in trade is comparatively a modern occupation, and it is highly beneficial if confined within legitimate and prudent limits. In this country the business has developed enormously within two or three decades and along lines that were unthought

of a few years ago, and which then would have been deemed impossible and extremely hazardous. The system, as we know it, is not in common practice anywhere else in the world."

All such paper obviously would be excluded by the legal definition of "commercial paper."

The New York Clearing House Association in the five months beginning October 27, 1907, accepted securities to the amount of $453,000,000, against which clearing-house certificates were issued. Of these securities, 73 per cent ($330,000,000) were commercial paper; but not a dollar was lost in that whole time of crisis through this use of commercial paper as security for certificates.

§ 7. The fact that the Reserve Association would be so closely restricted to business based upon commercial paper offered to it is an important consideration in connection with the question how far there is ground for fear of over-expansion of its discounts. This matter can be dealt with clearly and conclusively by a reference to the nature of commercial paper and the character of the operations out of which it grows, as contrasted with other kinds of bank loans. The danger of inflation or over-extension of credit is one which grows out of the action of banks in converting too many obligations or forms of property into immediate means of payment. A borrower or group of borrowers presents to the banks collateral of some kind which is considered undoubted security by the institutions to which it is offered. Then a loan is made on the strength of it. This loan may or may not be liquidated at maturity, or it may be met by making another loan of equal amount. When loans are paid only by contracting new ones, so that the fluid funds originally advanced have become tied up in fixed forms, inflation or overlending has occurred.

Protection Against Inflation

As already pointed out, the essential characteristic of commercial paper, which distinguishes it from other classes of bank security, is that it grows out of an actual transaction. It therefore provides its own means of liquidation under ordinary conditions. A does not sell to B because he thinks that at some time in the future B may be able to make a profit on some investments, but because he knows that B intends to dispose of his goods either by working them up into another form or by selling them direct to the consumer, and that in either case, the goods themselves are wanted for consumption purposes, so that the current labor and productive power of the community, on the basis of already exist-

ing investments, will provide the means of liquidation. Dishonesty may exist in a given case, and thus there may be loss, but the aggregate of the commercial paper of the country must be sound—as sound as the general business of the community itself. The business of discounting this paper is nothing more than the business of supplying liquid funds for a short time to those who need them in order to continue the productive process. It is not the taking of a chance upon the possible, or even probable, results of investment, but is merely a part of a process of division of labor, whereby the fluid resources of the community are placed at the disposal of those who need them, in return for a fair consideration.

Practical Tests of Commercial Paper

This characteristic of commercial paper has enabled the community to develop a mode of testing its goodness which does not exist in the case of any other kind of bank security. By means of credit organizations and institutions, it is possible to ascertain, as accurately as human knowledge can ever ascertain anything relating to the future, exactly what pieces of commercial paper are likely to be unsound. Credit agencies, collection institutions, credit departments in banks, corporation reports, the special reports of accountants, and many similar devices, are all available for the purpose of weeding out such commercial paper as is not trustworthy or reliable. Usually, banks which make loans on commercial paper prefer to obtain their own information as to the solvency of the makers of the paper, rather than to get it second-hand from others. The larger they are, the wider their clientèle, the better organized they are for the purpose of tracing the operations of the makers of commercial paper, the less cause there is for reliance upon outside agencies. Such institutions as the banks of England, France and Germany are thoroughly familiar with the character of the paper which comes to them for rediscount or for direct discount. They seldom lose.

The same situation would exist under a Reserve Association plan, such as has been suggested. The Reserve Association would be able to obtain knowledge as to the commercial paper of different sections of the country through its various branches and the associations of banks which were subsidiary to them. There would be no reason why it should ever be misled regarding the goodness of the paper presented to it. If, for the reasons already stated, it be true that commercial paper, being the outgrowth of actual transactions, practically provides its own means of liquidation where all is bona fide and honest; and if it be further true, as just shown,

Protection to Reserve Association Against Over-Expansion

that a large institution, enlisting the coöperation of banks and credit institutions everywhere, can practically eliminate every element of dishonesty or unsoundness in such paper, it will evidently be true that the loans made on this basis by such an institution will be absolutely sound. They cannot become "inflated," since they will be merely coterminous with the business to which they relate, and will involve no element of hazard or of future uncertainty. By limiting the operations of the institution to this class of security, and by eliminating every other class except under unusual conditions specially provided for, the funds of the Reserve Association are, not only absolutely safeguarded from speculative uses, but are protected by the only system of guarantee which is possible in banking—the placing of the combined banking and business judgment of the community behind the assets of the institution.

CHAPTER VI

ACCEPTANCES AND A DISCOUNT MARKET

1. European Accepted Bills of Exchange—2. American Promissory Notes—3. National Banks Cannot Accept Bills of Exchange—4. A Discount Market—5. Danger of Over-Expansion—6. The Rate of Discount—7. Uniform Rate of Discount in United States.

§1. In getting a loan, different forms are used in different countries, due to different business customs. In the United States borrowing at a bank is accomplished by the borrower giving the bank his promissory note for the term of the loan. It is quite otherwise in Europe. There, the bill of exchange is the common instrument of credit. A bill of exchange is an order drawn by the seller of goods, A, upon the buyer, B, asking B to pay (on demand, or at a given time) to C, a sum of money. The actual form of a sight bill of exchange is as follows:

European Acceptances

> New York, January 1, 1912.
>
> **At sight of this first bill of exchange (second and third unpaid), pay to the order of C, £10,000, value received, and charge the sum to the account of**
>
> **A (exporter from U. S.).**
>
> **To B (buyer from A), London.**

If B accepts the bill by writing the word "accepted" across its face, with his signature and the date, it becomes an obligation of B, who on presentation assumes the payment at maturity to C. Accepted bills of exchange are thus the common form of paper at European banks.

A particular class of accepted bills of exchange, known as "bankers' bills," forms a considerable part of the assets of European banks in their item of loans. That is, a borrower may secure a loan (for say, 90 days) from a bank, by drawing a bill on the bank, which accepts the bill because of an arrangement previously made between the bank and the drawer. Such a bill is immediately

Bankers' Bills

salable wherever the accepting bank is known, and the drawer is thus able to obtain funds without delay. There are various ways of making the bills, but the essential element as above, is contained in them all. For instance, the debtor, B, may draw a bill on the bank, instructing it to pay A, the seller of the goods, and if accepted, the payment to A is secured by the credit of the bank. The relation of the accepting bank to the drawer, B, is a matter solely affecting the bank and B, the borrower. That relation is, in essence, the usual one existing between a borrower and the lending bank—no matter what may be the peculiar legal forms entered into by which the borrower secures the bank for the loan. The credit essence is the same—even though the legal forms for repayment differ—whether a promissory note is given as in the United States, or a bill of exchange with assurances of payment at maturity, as in Europe.

When a European bank makes a loan to a customer by accepting his bill drawn on the bank, it may be based on the borrower's general standing—just as when, in the United States, a discount is granted on the one-name promissory paper of a person, or firm, of high standing. In either case the risk to the bank is much the same. But, in Europe, as well as here, the bank may exact security in addition to the signature of the borrower. For instance, an importer may wish a loan to pay for goods in warehouse, or in transit; the bank may agree to accept the bill as soon as the drawer has deposited with the bank the bills of lading, or other documents, covering the shipment of the goods; and the bank may next give the borrower an opportunity to dispose of the goods upon receiving a trust receipt. Still the relation between the borrower and the accepting bank is a primary matter. In Europe the practice is for the borrower to give the bank an agreement, duly signed, to hold the bank harmless for accepting the bill, to provide for the bank funds sufficient to meet the bill three days prior to the date of maturity, and to pay the bank the market rate of discount and a commission (varying according to the standing of the borrower and the time the bill is to run).

Documentary Security

§2. As has been said, the direct promissory note of a borrower to the lender is the usual form of credit in the United States. As previously shown (see Chapter V), prime commercial paper may be one-name paper; while two-name trade paper may not be so

desirable. That is, the form of credit likely to show the nature of the transaction—which appears also in the bill of exchange—is not necessarily the best paper offered to the banks. On the other hand, the paper of the firms in highest standing does not on its face disclose the nature of the transaction. However this may be, the best managed banks by experience and judgment have worked out a system under which they know definitely what paper is good, and what is bad. Since the paper itself does not convey information as to the trade transaction, the bank will carry in its *dossier* complete details of the extent and character of the customer's business and borrowings. To be sure, the bank—except through Clearing-House Committees, or by some such central credit bureau as that proposed by the Comptroller of the Currency—may not know how extensively the borrower has extended his credit with other banks.

Promissory Note Usual Form of Credit Here

In the last few decades, banking operations have been influenced by the same conditions which have led to the formation of large industrial combinations. Formerly, producers and merchants obtained loans from the local banks by getting their promissory notes discounted at home. But as the operations of many firms developed extensively, their borrowing needs soon increased beyond the small resources of the local banks. Those which entered into large combinations had their discounts necessarily taken care of through the management located in the largest financial centers. But the vast number of independent producers of all kinds, not only in small towns, but in the large cities, as their need of loans increased with increasing business, broke up a large loan into small pieces which were placed in the hands of note-brokers to be sold to banks in all parts of the country. This business of the note-brokers has increased amazingly; the broker can parade the good qualities of a firm's paper to a bank in a way not permissible to the drawer himself. Thus in lieu of a discount market for paper in the United States, a great amount of promissory notes has been widely distributed and sold by note-brokers.

Development of Note-Brokers

The safety of the usual form of credit used in this country—the promissory note—depends upon the standing of the maker, varying as widely as the standing of men and industrial concerns all over the country. Obviously, then, our commercial paper has no uniform quality or security, and consequently the rate of discount varies as much as the standing of the borrower. We have no discount market—such as that known in Europe for accepted

bills of exchange—beyond that provided by the note-brokers, who peddle out the paper wherever it can be sold.

In the absence of a discount market, the banks themselves, when in need of cash resources, have no open way of disposing of their paper. Rediscounting their paper is regarded as an evidence of weakness and that the condition of their reserves is unsatisfactory. Hence the banks fear to have it known that they are rediscounting their paper. Nevertheless, the same thing in another form is constantly and necessarily going on. Perhaps a director of the bank is used personally as a means of getting a rediscount upon assets of the bank. In one way or another, rediscounting of promissory notes is going on, and is probably inevitable under existing conditions. Single-name promissory notes have no universality of credit, and hence could not feed a discount market. Such paper can not be instantly turned into cash in an open market.

Rediscounting Not Favored

The objection of banks to rediscounting their paper is due to the fact that it offers a note whose security depends solely on the standing of its maker. If the bank endorses it for rediscount, the lending bank which rediscounts it makes the loan wholly on the strength of the endorsing bank; it is, in effect, a loan directly to that bank; and it practically creates accommodation paper in favor of the borrowing bank. This is doubtless the reason why rediscounting is supposed to injure the credit of a bank. If, however, a country bank had invested its idle funds in bills accepted by a well-known bank, and wished to realize on them instantly, the rediscount would not be a loan to the country bank, and would not affect the bank's credit. It would indicate only that the country bank had found a more profitable employment of its funds, or that it wished to increase its reserves. That is, acceptances would serve as a desirable "secondary reserve," which could be instantly turned into cash in the open market; while promissory notes, rediscounted, mean an appeal to a single correspondent bank for accommodation.

Why Rediscounting Is Now Suspected

§3. By the decisions of the courts under the national bank act, national banks are apparently not permitted to accept time bills of exchange. The act authorizes banks organized under it to carry on the business of banking "by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security." "It

Definition of the Business of National Banks

is settled," says the Supreme Court[1], "that the United States statutes relative to national banks constitute the measure of the authority of such corporations, and that they cannot rightfully exercise any powers except those expressly granted, or which are incidental to carrying on the business for which they are established." Under these powers a national bank may certify checks;[2] it may, in selling or rediscounting paper held by it, bind itself by indorsing or guaranteeing the payment of the paper;[3] it may, for the purpose of securing payment of a debt due it, guarantee the payment of notes delivered to it (but not payable to it) by the debtor in order that the bank should then negotiate them to another;[4] a bank may permit an over-draft because this may be merely one method of loaning money; but, on the other hand, it is held in many cases decided by State and the lower Federal courts (though the question seems not to have been directly passed upon by the United States Supreme Court) that a national bank can not lend its credit,[5] and particularly can not make accommodation acceptances and guarantees for the benefit of third persons,[6] even though it received a compensation for doing so.[7]

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[1] *California Bank v. Kennedy*, 167 U. S. 362.

[2] *Merchants' Bank v. State Bank*, 10 Wall. (77 U. S.) 604.

[3] *Peoples' Bank v. National Bank*, 101 U. S. 181; *United States National Bank v. First National Bank*, 24 C. C. A. 597, 79 Fed. 296.

[4] *Peoples' Bank v. National Bank, supra.*

[5] Thus in *Seligman v. Charlottesville Nat. Bank*, 3 Hughes 647, 21 Fed. Cas., p. 1036, it is said by Judge Bond in the circuit court: "The bank is allowed [by the statute] to lend money upon personal security; but it must be money that it loans, not its credit." This language has been repeated in many cases. In this case a national bank had undertaken, upon receiving a deposit of collaterals, to guarantee to another bank a letter of credit issued by the latter to a customer of the former; *Held* to be *ultra vires.*

[6] See *Seligman v. Bank, supra; National Bank v. Atkinson*, 55 Fed. 465, affirmed, 10 C. C. A. 87, 61 Fed. 809; *Commercial Nat. Bank v. Pirie*, 27 C. C. A. 171, 82 Fed. 799; *Merchants' Bank v. Baird*, 90 C. C. A. 338, 160 Fed. 642; *Norton v. Derry Nat. Bank*, 61 N. H. 589; *National Bank v. Sixth Nat. Bank*, 212 Pa. 238; *Thilmany v. Iowa Nat. Bank*, 108 Iowa 333; *First Nat. Bank v. American Nat. Bank*, 173 Mo. 153; *First Nat. Bank v. Monroe*, 135 Ga. 614; *Fidelity Co. v. National Bank* (Tex. Civ. App.), 106 S. W. 782.

Contra: Hutchins v. Planters' Nat. Bank, 128 N. Car. 72; *Farmers' Nat. Bank v. Illinois Nat. Bank*, 146 Ill. App. 136.

No one of the cases cited involved the precise question herein involved.

[7] It might, however, be liable, not on the guaranty, but *quasi* contractually to the extent of any consideration actually received by it in the course of its business. See *Appleton v. Citizens' Nat. Bank*, 116 N. Y. App. Div. 404, reversed, 190 N. Y. 417, affirmed, 216 U. S. 196. See also *Rankin v. Emigh*, 218 U. S. 27.

If a bank were to give an acceptance which was to be paid soon, independently of the question whether the customer had then provided funds to meet it, it would not differ in substance from a loan of the money, and might not be deemed to differ in legal effect. But if the acceptance were of a time bill and it was the agreement and expectation that the customer should provide funds to meet it before maturity, so that the bank would not expect to advance its own money at all, it would seem to be nothing else than a loan of credit and not a loan of money in any sense.

Resemblances and Differences Between Acceptances and Loans

It may be conceded that there is little apparent difference in result between the case in which a man gives his note to the bank secured by collateral, has the proceeds placed to his credit, and then draws his own check upon the deposit; and the case where he agrees to indemnify the bank, deposits the same collateral, and is permitted to draw a bill upon the bank, which it accepts, and he then uses the acceptance instead of his own check, as in the case first supposed. In both cases the bank relies upon his responsibility and the value of the collateral. It may be that the bank would be just as *safe* in the latter case as in the former. It would not, however be in an equally *convenient* situation, if it should desire to transfer or realize upon these securities, since the customer's note secured by collateral would be negotiable and readily rediscounted, while his agreement to indemnify secured by the same collateral would not be negotiable or readily used in the market.[8] From the standpoint of the statute, however, there would be quite a distinct difference in form and some difference in effect. In one case the bank would *lend money* on personal security, which is within the language of the Act, and in the other case it would *lend credit* on personal security, which seems to be outside the language of the Act.

[8]This, of course, proceeds upon the assumption that what the customer gives the bank is, as suggested in an earlier section, an agreement to indemnify the bank against liability upon the acceptance and to provide funds in ample time to meet it. The customer might, indeed, give the bank his note for the amount of the acceptance, payable before the latter was to mature; and in that event the distinction in the form of the security held by the bank would disappear.

Where the customer gives an ordinary agreement to indemnify the bank, as at first supposed, there would usually, in addition to the disadvantage of non-negotiability mentioned in the text, be some differences in procedure and evidence in enforcing an agreement to indemnify as compared with the more liquidated and flexible negotiable note.

It is also possible that the Supreme Court of the United States might, in view of the practical and economic similarity of the two transactions, hold that the differences in form were immaterial.

It is also, of course, true that the difficulty is merely one of charter or statutory power, which may be removed by appropriate legislation.

Bank Acceptances In Europe

§4. In Europe, the general use of bills of exchange, and their acceptance by banks, has led to the creation of a discount market in London, Paris, Amsterdam, Berlin, and other centers. When the bill is accepted, the risk of payment is assumed by the bank. The security of the paper is no longer dependent upon the varying standing of the drawer, but upon the standing of the bank; consequently it possesses uniform security in any market where the bank is known. The case for creating a discount market in this country is stated as follows by Mr. Lawrence M. Jacobs:[1]

> "The weakness of our banking system as compared with the systems of Europe may very certainly be attributed in part to the omission of the bank act to permit bank acceptances. It is a weakness, furthermore, which involves the country in serious economic loss. Without a national discount market, the great majority of our merchants and manufacturers are compelled to confine their borrowings to American capital; either through the discounting of their paper with their local banks or through its sale to note brokers. All but the strongest and largest are practically excluded from the benefits of foreign competition for their paper. Aside from the great concerns with international ramifications, which are able to arrange their own credits abroad, our merchants and manufacturers are not benefited by low foreign discount rates, except in so far as note brokers, who make it a practice to borrow in Europe with commercial paper as collateral, are better able to finance their purchases. What is more, they receive relatively little advantage from an accumulation of funds in New York banks. Low call loan rates have an indirect rather than a direct effect on the rate which the mercantile community has to pay for money. Low call rates, in other words, are an indication more especially of stagnation in the stock market than of a lack of demand for accommodation from merchants and manufacturers. Such rates do not act as a stimulus to trade in general any more than high call rates act as an immediate check to overexpansion.
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> "It is not only in our domestic trade that the country suffers through the want of a discount market. Without bank acceptances we are at a distinct disadvantage in connection with our foreign

[1] National Monetary Commission, "Bank Acceptances."

trade. Our importers, unable to open credits with their banks, as is done abroad, are not in a position to finance their purchases upon as favorable a basis as the importers in other countries, as English cotton-spinners, for example. The English spinner about to purchase cotton in America arranges for his bank to accept sixty or ninety days' sight bills drawn on it by the American shipper. The latter draws his bills on the English bank and attaches the documents covering the shipment, such as the bills of lading, insurance certificates, invoices, etc. He then sells them to a New York bank, thereby receiving immediate payment for his cotton. The New York bank forwards the bills to its London correspondent, which presents them for acceptance to the bank upon which they are drawn. Upon the acceptance of the bills the documents are delivered to the accepting bank, which then turns them over to the spinner upon whatever arrangement has previously been made. The accepted bills are discounted by the New York bank in London and the proceeds placed to its credit there. The New York bank can afford to pay a high rate for such bills, as they are drawn on prime bankers, rendering certain their ultimate payment. The purchase of the bills does not, moreover, necessitate any outlay of money, as, against the credit to be received through the discount of the bills, the New York bank can immediately sell its checks on London.

"Without such banking facilities—that is, the ability to arrange with his bank to accept time bills drawn on it by a foreign shipper, the American importer is compelled to finance his purchases in either one of two ways. He may pay for the goods at once by remitting funds direct to the shipper. This, however, ordinarily necessitates the negotiation by the importer of a loan on his promissory note. If he is not in a position to secure such an advance he must shift the burden of providing funds to finance the shipment, from the time it is forwarded until it is to be paid for, upon the foreign shipper, who is then in a position to exact terms more favorable to himself through an adjustment of prices. The practice in connection with this method of making payment for foreign purchases is for the shipper to draw his draft on the American importer and turn it over to his banker to forward for collection. Such drafts, drawn as they are on individual importers and not on banks whose standing is well known abroad, must be sent for collection since there is no general market for them. Practically the only way in which a foreign shipper can realize immediately on bills of this character is to dispose of them to his own banker or get him to make an advance on them.

"Either of these two methods of financing our imports is expensive even when the time between the shipment and the receipt of the goods is short. When the time is much longer, as in the case of imports from South America and the Far East, the cost is almost prohibitive—that is, so great that we cannot compete on an even basis with foreign buyers. In fact, we might be practi-

cally excluded from these markets if a makeshift were not possible. Our importer gets around our lack of banking facilities by having his bank arrange a credit with its London correspondent. He receives an undertaking, called a commercial letter of credit, giving the terms of the credit—that is, the name of the London bank upon which the bills are to be drawn, the amount which may be drawn, the character of the goods which are to be purchased, the tenor of the bills, and the documents which must accompany them. On the strength of such a letter of credit, the shipper in South America, for example, is able to dispose of his bills on London and thus receive immediate payment for his goods. The local bank which buys the bills sends them with the documents to its London correspondent, which presents the bills to the bank on which they are drawn—that is, the bank with which the credit was opened. Upon the acceptance of the bills the documents are delivered. They are then sent by the London accepting bank to the New York bank which opened the credit and the latter delivers them to the importer against his trust receipt. Twelve days prior to the maturity of the bills in London the New York bank presents a statement to the importer indicating the amount of pounds sterling which must be remitted to London to provide for their payment at maturity or rather a bill stated in dollars for the amount of pounds sterling drawn under the credit. In this purchase of exchange the importer makes payment for his goods. This method while workable is obviously cumbersome, yet it is practically the only one which the American importer can follow in connection with such imports. It is expensive for the importer, for not only must he pay his bank a commission for arranging the credit, but there is included in this commission a charge made by the London bank for its acceptance. Further than that, the importer must take a material risk in exchange. At the time a credit is opened the cost of remitting, say £10,000, to take up the bills in London, might be only $48,600, or at the rate of $4.86, whereas by the time the bills actually mature exchange may have risen and cost him $4.87, or $48,700.

"As a result of the inability of our banks to finance imports, through the acceptance of time bills, American importers are then made dependent to a large extent upon London, and are required to pay London a considerable annual tribute in the way of acceptance commissions. This practice not only adds to the importance of London and militates against the development of New York as a financial center, but it at the same time works serious injury to our export trade. Since time bills cannot be drawn on our banks from foreign points against shipments of goods to the United States, there are consequently in such foreign countries very few bills which can be purchased for remittance to the United States in payment for goods which have been bought here. In other words, under our present banking system our imports do not create a supply of exchange on New York, for example, which can be sold

in foreign countries to those who have payments to make in New York. This means that our exporters are also, to their great disadvantage, made dependent upon London. It means that when they are shipping goods to South America and to the Orient they cannot, when they are subject to competition, advantageously bill them in United States dollars. They naturally do not care to value their goods in local currency—that is, in the money of the country to which the goods are going—so their only alternative is to value them in francs or marks or sterling, preferably the latter, owing to the distribution and extent of British trade, creating throughout the world, as it does under the English banking system, a fairly constant supply of and demand for exchange on London. When we come to bill our goods in sterling, however, it is at once seen that our exporters are obliged to take a risk of exchange, which is a serious handicap when competing with British exporters. Our exporters who are to receive payment for their goods in sterling must previously decide on what rate of exchange will make the transaction profitable. If, in an effort to safeguard themselves against a loss in exchange, they calculate on too low a rate for the ultimate conversion of their sterling into dollars, their prices become unfavorable compared to those made by British exporters and they lose the business. If they do not calculate on a sufficiently low rate, they get the business, but lose money on the transaction through a loss in exchange.

"The prohibition of bank acceptances not only acts as a hamper upon our domestic and foreign trade, but is detrimental to our banks as well. It is the small country bank which is chiefly affected. The business of the country bank, so far as the employment of its funds is concerned, may be divided into two classes—that which relates to advances to local customers and that connected with the investment of its surplus. It is in respect to the latter that the matter of acceptances is important. Under the present limitations of the national bank act, there are three principal ways in which a country bank may render its surplus funds productive. It may deposit them with its reserve agent. This means a low interest return, too low in fact to permit of more than a relatively small amount being thus employed. It may invest in bonds. In this way an increased interest return can be secured, providing a wise selection of securities is made, but it partakes of the nature of speculation. The third way is to buy commercial paper. Such purchases give an ample interest return and there is no savor of speculation. Even this method of employing a bank's funds, however, is far from satisfactory. It means the investment in a security for the strength of which the bank must depend on the word of note-brokers, the rating of the mercantile agencies, or the opinion of some correspondent bank. It means, furthermore, the tying up of the bank's funds for a fixed period. If national banks were permitted to accept time bills, the country bank could then invest its funds in paper bearing the guaranty of some great

bank with whose standing it is perfectly familiar. Risk such as now has to be taken would be eliminated. What is vital, however, is that with a national discount market an investment in a bank-accepted bill is one which could be realized upon immediately.

"Since the reserves of interior banks are so largely concentrated with them and it is essential that they keep their assets in an especially liquid condition, the prohibition of bank acceptances works injury to the banks at the country's financial center, New York, in a different way. It deprives them of what London banks, for example, have—that is, a mass of the soundest securities against which to loan their money on call or in which they may invest their funds for very brief periods—bills of exchange, covering genuine commercial transactions, bearing the acceptance of prime bankers. Unquestionably such securities as a basis for loans are preferable to stocks and bonds, but without them New York banks must have recourse to day-to-day loans on the Stock Exchange. Moreover, when the demand for such loans is limited, New York banks are forced into the keenest kind of competition, a competition which, as has been pointed out, is not only of little benefit to trade but which, through the lowering of the money rate, actually stimulates speculation. Furthermore, without a steady money rate such as exists in countries possessing discount markets, New York banks are left with no reasonable or satisfactory basis upon which to fix a rate of interest to pay for the deposits of country banks. In London interest on bank deposits is fixed at a certain percentage below the Bank of England discount rate, usually 1½ per cent—that is, a rate which fluctuates with the value of money and normally leaves a certain margin of profit to the London bank. The same practice is followed in all the great financial centers of Europe. With us, country banks receive a fixed rate of interest for their deposits, usually 2 per cent the year round, regardless of fluctuations in the value of money. The unscientific nature of such a rate is obvious. When the call loan rate is high, country banks do not receive interest in proportion to the value of their deposits. When it is low the New York banks pay more interest than the deposits are worth. In the latter instance the New York banks are forced into injurious competition with one another. They are in much the same position as competing railroads were earlier in our history, with results similarly baneful. With the railroads it was worth while to secure traffic even at a losing rate, as no matter what the return, it helped, if only a little, toward meeting fixed charges. Oftentimes with the New York banks today any rate which they can secure for their money, whether losing or not, is acceptable as helping to meet this fixed interest charge on bank deposits. To pay 2 per cent for deposits and to keep a 25 per cent reserve a bank must loan its money at 2¾ per cent to come out even, taking into consideration the actual expense of making and recording the transaction. It is better to loan at 1¾ per cent, however, than to let the money lie

idle. It is better to lose 1 per cent than to lose the entire 2¾ per cent, as would be done in case no loans at all were made, clerk-hire being just as much a fixed charge as interest. With the amendment of the national bank act, to permit the acceptance of time bills, such ruinous competition would cease. The funds of the banks would come to be principally invested in trade paper and stock-exchange loans would be relegated to a position of secondary importance, as in London and on the Continent. The field for the investment of their deposits would be greatly broadened, to the benefit both of the banks and trade in general.

"To remedy this primary defect in our banking system, to trade along the lines which have proved so advantageous in other countries, to provide negotiable paper of a character suitable to the investment of foreign funds, paper which can not only be discounted but rediscounted, to give trade the advantage of bank surpluses accumulated both in the country at large and in New York, to lessen the evils of speculation, to afford a reasonable basis for the calculation of interest rates on bank deposits in central reserve cities, to bring New York into the circle of those financial centers between which funds move naturally as discount rates rise or decline, to secure the advantage of the competition of foreign capital for our trade paper—can be put in the way of accomplishment by the insertion of a paragraph or two in the national bank act.

"To permit bank acceptances would not require the revision of the entire bank act. To remove the barrier to scientific banking, as it is known abroad, no complicated piece of legislation would be necessary. Time only would be required for the development of a great national discount market."

§5. The permission to all subscribing national banks to accept time bills of exchange, is a part of the banking reform measure before the country. It is obvious that acceptances are a form of loan, differing from promissory notes only in the legal forms adopted for protecting the bank against the borrower. There should, therefore, be the same precautions taken against over-expansion in the case of acceptances as in the case of other paper.

Restrictions on Acceptances

The first essential restriction, of course, is that they should arise out of commercial transactions; indeed for bills of exchange drawn by sellers on buyers this test is more easily made than for promissory notes. If drawn on real transactions, there can be little danger of over-expansion. In addition, it is provided that they should not have more than four months to run, and be properly secured by the usual documentary evidences, such as bills of lading, etc. Besides these restrictions, the total amount allowed should not

exceed one-half the capital and surplus of the accepting bank. Moreover, when the paper is presented to the National Reserve Association for sale, the acceptor must be a bank or firm of unquestioned financial responsibility; the paper must have not over 90 days to run; be known as prime bills; and bear the endorsement of the selling bank, which must be other than the accepting bank.

Open Market for Acceptances

Of course, the market for acceptances would not be confined to the National Reserve Association. While only well-known banks will probably resort to acceptances, yet it is a resort permissible to any small bank. A buyer of cotton or grain could arrange to draw on a country bank and have the bill accepted, under the plan proposed. Such an acceptance could be sold in the open market for paper wherever that bank is known; but, as already noted, no subscribing bank, large or small, could create acceptances to exceed one-half its capital and surplus. That is, a bank with a capital of $25,000 and a surplus of $5,000 would be limited to $15,000 of acceptances.

Having thus reached its limit of acceptances, when good cotton or grain paper was offered it, a bank could still discount promissory notes, provided its reserves allowed; but if its reserves began to fall below the legal limit, it could then take its cotton or grain paper to the branch of the National Reserve Association for rediscount, and with the proceeds add to its reserves. But, in no case could such bank, country or city, obtain rediscounts in excess of its capital. As a result, over-expansion seems to be well guarded against, apart from the requirement that the paper should be commercial, and not used for carrying stock exchange securities.

§6. Regarding rates, Mr. Jacobs says:

Stability of Foreign Discount Rates

"In European centers the discount rate is the rate upon which the eyes of the financial community are fixed. In New York it is the rate for day-to-day loans on the stock exchange. The advantage in character of the one rate over the other clearly indicates an important advantage of European banking systems over our own. In the first place, the European discount rate bears a very direct relation to trade conditions. Its fluctuations depend primarily on the demand for and supply of bills which owe their origin to trade transactions, as balanced against the demand for and supply of money. If trade is active, the supply of bills becomes large, rapidly absorbing the loanable funds of the banks. As these surplus funds become less and less, banks are unwilling to discount except at advanced rates. If trade is slack, less accommodation from bankers in the way of acceptances is required, bills

become fewer in number, the competition for them in the discount market more keen, and the rate of discount declines. Low rates are an incentive to business and advancing rates act as a natural check. The New York call-loan rate, on the other hand, bears only an indirect relation to trade conditions. Its day-to-day fluctuations register mainly the speculative and investment demand for stocks. Low rates, instead of being an incentive to the revival of trade, are rather made the basis for speculative operations in securities.

"The striking difference, however, between European discount rates and the New York call-loan rates is that the former are comparatively stable and the latter subject to most violent oscillations. Foreign discount rates, as bank reserves become depleted, advance by fractions of 1 per cent. In New York the money rate advances on occasion 10 per cent at a time, mounting by leaps and bounds from 20 per cent to 100 per cent in times of stress.

"There are two principal reasons for the stability of foreign discount rates. In the first place, trade expands and contracts gradually, so trade bills multiply or diminish in number little by little, producing a gradual increase or decrease in the demand for money. In the second place, discount rates are steady because there is a free movement of funds between the countries possessing great discount markets. Between London and Paris money flows as the balance of indebtedness changes, modified by the discount rates at the respective centers. If France owes England more than England owes France, money will tend to flow from Paris to London in settlement of this balance of indebtedness. If the London discount rate is higher than that of Paris, the movement will be accentuated by the movement of French funds to London for investment in sterling bills of exchange—that is, in bills drawn on and accepted by prime English banks and bankers. If the Paris discount rate is higher than that of London, there will be a natural offset to the tendency of funds to move to London in settlement of this balance of indebtedness. Briefly, money seeks investment in those centers where the discount rates are highest. If the discount rate is 1½ per cent in Paris and 2¾ per cent in London, Paris bankers remit funds to London for investment in sterling bills. This increases the supply of money competing for bills in London and forces the discount rate downward. At the same time the drain of funds from Paris results in lessening the competition for bills in that center and the Paris discount rate rises. Thus it is that funds freely move to and fro between London, Paris, Berlin and Amsterdam, an exact equality in rates being prevented largely by the fact that the discount markets in these cities differ in size and that there is not in each an equally free market for gold. For example, the Paris discount market is broader than that of Amsterdam, and there is consequently less risk in exchange in forwarding funds to Paris for investment than to Amsterdam. That the Paris discount rate should rule somewhat lower than that

of Amsterdam is accordingly natural. Sterling bills, moreover, are favored above German bills because London possesses a freer market for gold than does Berlin—that is, a holder of credit in London can count on being able not only to convert it into gold, but to withdraw the gold, whereas artificial restrictions are sometimes placed on the withdrawal of gold from Germany. In consequence, apart from any consideration as to relative size of the two money markets, there is a tendency for funds to remain in or to move to London even when the Berlin discount rate is slightly higher.

"There are likewise two principal reasons for the instability of the money rate in New York. The first is that the demand for loans for the purpose of speculative operations in stocks does not increase gradually. A few weeks at most are sufficient for a large speculative movement to develop. At the same time the profits in successful stock speculation are so great compared with those in trade that the matter of whether the call rate is 6 per cent or 10 per cent is relatively unimportant. So it is that only very sharp and very considerable advances in the call rate are effective in checking the demand for money. The second reason is that an advance in the call rate above the level of foreign discount rates does not serve directly to attract funds from Europe. The continuance of high rates can not be depended upon, and furthermore, while London bankers, for example, may be willing to loan money to finance speculative movements at home, to make advances for similar purposes abroad is quite another matter. In fact, the higher the call rate is the less the European banker is inclined to lend his money in the new York market. New York is in a class by itself. Without bank-accepted bills it can have no discount market. Without a discount market, funds can not move to it as they do between the financial centers of Europe, because there are no bank-accepted bills in which foreign banks can invest. Our commercial paper is not suitable. Foreign banks will not purchase it because they are not acquainted with, or sure of the rating of, miscellaneous mercantile establishments, and because such paper could not be readily disposed of in case it became necessary or profitable to withdraw funds from New York for remittance elsewhere."

§7. The creation of a discount market in the United States would introduce here the phenomena of so-called market and bank rates so common in Europe. The former are the rates established on the open market by the competition of all banks and other investors in this class of securities and the latter is the rate fixed by the central banks. The market rates on different classes of bills are different and, as has been indicated, they fluctuate in accordance with the demand and supply of bills on the one hand and of

Market and Bank Rates

funds on the other. The bank rate is much more stable. In France it has at times remained stationary for two or more years, and a stationary rate for several months is common in all countries which have well organized central banks. It is also a uniform rate throughout the entire country, the central bank offering its services on the same terms to all sections, banks and persons.

In the determination of its rate of discount the National Reserve Association would be influenced by considerations similar to those which actuate the banking institutions of Europe, namely, the state of its reserves, the foreign exchanges and the general conditions of credit. In the open market here, as in Europe, there would be different rates on different classes of bills and these rates would fluctuate with the varying conditions of supply and demand.

What Makes the Bank Rate?

In Europe the market rates are usually below the bank rate. Only occasionally and for short periods do they rise above it. On this account ordinarily most of the discounting is done in the open market, the central banks rediscounting for other banks as their needs for cash and notes dictate. When for any reason the market rates soar above the bank rate, the latter is apt also to be raised in order to prevent too great an increase of the Central Bank's discounts, and, if it does not rise, the transfer of customers from the market to the Central Bank is certain to diminish the demand there and thus to bring the market rates back to their normal state.

In the United States a peculiar situation exists on account of the wide differences between the rates in different sections of the country and on account of the relatively high rates everywhere. The query arises whether it would be practicable for the National Reserve Association to maintain a uniform rate throughout the country under these conditions. Would not its rate be continually below the market rates in many sections of the country and would not the banks in those sections find it profitable to borrow heavily from the Reserve Association in order to loan at higher rates at home and thus to make too heavy drafts upon the Association's resources and to over-expand credit in those regions?

Could the Reserve Association Maintain a Uniform Rate?

Before the effect of a uniform rate of discount by a National Reserve Association can be appreciated, notice must be taken of the fact that the chief cause for the differences now prevailing between loan rates in different sections is the absence at the present time of suitable machinery for the distribution of the funds of the coun-

try, and that the rates under consideration pertain only to commercial paper of short maturities.

Causes of Different Rates in Different Sections Removed by Reserve Association

Barring the risks involved in loans to new enterprises managed by more or less inexperienced men in undeveloped regions, the only reason for abnormally high rates in portions of the West and South is the lack of adequate banking capital and the absence of such coöperation between the banks of the entire country as make it practicable and safe for banks in the older and richer sections to send a portion of their resources for investment to the less developed and under-supplied sections.

The organization of a National Reserve Association would remedy this latter difficulty. It would standardize those forms of commercial paper which it is permitted to discount and create a national market for them. All banks could and would enter this market when they had surplus funds to invest, and these standard forms of paper, originating in the regions in which rates are now abnormally high, would enter the market on the same terms as similar paper originating in other sections. The organization of a National Reserve Association would result in drawing a sharp line of distinction for the first time in this country between commercial and investment paper. It would create a national market for the former; and, for those classes which the Association is permitted to discount (namely, paper with twenty-eight days of maturity, four-months paper and bank acceptances) it would establish standard rates which, with the exception of minor variations due to differences in the domestic rates of exchange at different points and the varying degrees of credit of the individuals, firms and corporations whose paper would be presented for discount, would be uniform throughout the United States.

Influences Tending to Establish Uniformity

The influences which would tend to enforce this uniformity would be the uniform rate of discount of the National Reserve Association for paper of the same quality without reference to the place of origin, and the competition of banks in the now relatively low-interest-rate sections. When the business men of any locality learn that their bankers are able to borrow from the Reserve Association on their paper at certain rates by merely adding the bank's endorsement, they will not long tolerate a charge to them in excess of the rate the banks pay the Association, plus a reasonable profit on the transaction; and they will not be obliged to tolerate it, because the fact that the National Reserve Association is freely dis-

counting the paper of these individuals, firms or corporations will give them credit on the open market and enable them to command the surplus resources of banks in other sections.

The uniformity of rates here under consideration should be understood to apply only to paper identical in quality and character. The National Reserve Association should be permitted to make different rates for the different classes of paper it is permitted to discount, and in making such differences it should be guided by the condition of the market and by its own needs; but whatever rate it establishes on a specified grade and class of paper should be uniform throughout the country. The alternative to such uniformity would be some kind of a sliding scale based on the rates charged in each locality, and this would have the disadvantage of keeping intact existing differences. The influence of the Association should be in the direction of a more equitable distribution of the country's banking resources and a greater uniformity in the price of banking accommodation to business men, farmers and others in every part of the country.

Different Rates on Different Classes of Paper

The establishment of substantial uniformity of rates on paper of the classes available for discount by the Reserve Association would tend toward the establishment of uniformity on commercial paper of the other classes, such as paper of longer maturities. Once the short-time paper of an individual, firm or corporation becomes accredited on the discount market, other paper of the same individual, firm or corporation would share in the benefits.

Paper which belongs to the investment rather than to the commercial class would doubtless still continue to command different rates in different sections of the country, since such rates depend in the last analysis primarily upon the dividend-paying character and prospects of the enterprises which issue it rather than upon the money market. The rates on such paper would continue as at present to be a matter of negotiation between the local banks and their customers. The facilities for the better distribution of the banking resources of the country supplied by the Reserve Association would also help better to distribute the country's investment capital and thus exert some influence in the direction of uniformity, even upon the rates of this kind of paper, but it probably would not be sufficient to overcome the influences tending in the opposite directions.

Rates on Investment Paper

Canada may serve as an excellent illustration of the fact that

adequate machinery for the distribution of a nation's loanable funds tends towards uniformity of rates. That country resembles our own in extent of territory, great differences in the development of different sections, character and density of population, and nature of the business transacted, and yet the differences between the rates charged for loans in the different sections of that country are very much less than in our own. The explanation of this is to be found in the Canadian banking system in which a few large banks with widely scattered branches enable the funds of the country and those imported from Europe and the United States to be easily and cheaply distributed to all sections according to their needs.

Canada as Illustration

A National Reserve Association would render this same service to the people of this country without interfering in any way with our system of independent banks and without introducing among us any of the difficulties involved in the branch bank system. It would render even more efficient service than the Canadian system in the direction of equalizing rates between the different sections of the country, because its own rates would be uniform and its influence would be everywhere felt, while the Canadian banks are under no compulsion to charge uniform rates and no single bank is represented in every section. The tendency towards uniformity in Canada is a result of the branch bank system and of competition between different institutions. There is wanting the influence of a single national institution with a uniform rate.

CHAPTER VII

SPECULATION AND CALL LOANS

1. Analysis of Bank Credit—2. Origin of Call Loans—3. Real Security for Commercial Loans—4. Extent of Call Loans—5. Development of Margin Trading From Call Loans—6. Banks Would Prefer Not to Lend for Speculative Purposes—7. How Discount Market Would Work—8. Reserve Association Would Be an Intermediary between Banks—9. Possibilities of Evading Charter Requirements as to Commercial Loans—10. Banks Would Protect Themselves.

§1. In studying the use that is made of bank credit the subject must be analyzed from two standpoints—(1) the effect of certain classes of credit upon the banks themselves, and (2) the conditions under which such credit is employed by those who get the loans. In this connection, probably the most fundamental question to be asked relates to the period for which the ordinary bank loan is made. This period is of interest because it has a direct relation to the fluidity of the bank's funds, because it has an important bearing upon the terms and conditions of commercial credit, and because the period of the loan shows to a certain extent the nature of the purposes for which the loan has been obtained.

Restrictions of National Bank Act

Recognizing these facts, the national bank act has been very specific with reference to the character of security which may be accepted behind a bank loan. It is not that banks needed to be safeguarded and kept from making loans on weak security. That is a matter which can be entrusted to the selfish interest of the bank with entire safety, while if corrupt managers are in charge of the bank there is very little use in attempting to protect stockholders and creditors by law. The reason why the law specifies with such care the kind of security that may be accepted, is that it is desired to keep the funds of banks in a fluid condition so as to insure as far as possible the constant liquidation of loans and to avoid the tying up of the funds in long period securities which might be hard to liquidate. Because of this, the bank act has

Purpose to Make Bank Funds Fluid

prohibited loans upon real estate security and has thrown other safeguards about certain classes of undertakings. But it has placed no restriction upon the amount of loans that banks might make on demand. Theoretically such loans are the most fluid type of bank assets. Since they are supposed to be collectible whenever the bank desires, they are, if good, the next thing to actual cash in hand, since they can presumably be gathered in at a day's notice. This is undoubtedly the assumption of the bank act. Had it been supposed that such loans were open to any special type of danger, there would have been an effort to protect them against that danger. But it can be seen that such absence of restriction was entirely based upon the assumption already suggested. If that assumption is baseless, such loans are no longer to be regarded as a fluid type of assets. Should it appear that they cannot be actually collected on demand, they at once pass into the class of doubtful or questionable accommodations. This is frequently the case, as can be seen from a study of that particular type of loan and an analysis of the security by which it is usually protected.

No Limit Placed on Call Loans

§2. As has already been noted, the essential character of a loan depends upon the kind of operation that gave rise to it. Of course the goodness of all loans is ultimately dependent upon the solvency of the persons who obtain the accommodation and that is tested by the extent of their ownership of wealth. But among a group of persons, all perfectly solvent in the long run, there is a great variety of borrowing power and an equally great variety of capacity to pay promptly. It will be found in every case that this variation depends upon the kind of business done and undertakings engaged in. As a rule, the length of time for which the borrower at a bank seeks to obtain accommodation is the average length of time required for turning over capital in the business in which he is engaged. Ordinary mercantile credits will run for 30, 60, or 90 days. During that period, goods have been placed on the market, disposed of, and the proceeds collected, thus furnishing a fund for use in settling with the bank.

Origin of Call Loans

Where a demand loan is made, there is no such term of credit, but the assumption is that the business can yield a given amount of cash at any time. Evidently this could be true only if the business were in position to dispose, at satisfactory prices, of such assets as might be necessary at any given time, and to obtain in exchange cash or immediate funds that could be used in payment

This is not the case in any commercial or industrial operation. Call loans are seldom found among mercantile or industrial paper, because the men engaged in retailing or manufacturing cannot afford to put themselves in a position where they are likely to be called upon suddenly for cash. They feel that they must know exactly when their obligations are going to mature, so that they can provide against them. The call loan may be regarded as synonymous for practical purposes with the loan for speculative ends. This is not invariably the case; as, for reasons of convenience on the part of either side in the transaction, an ordinary loan may be made in the demand form. But for the most part, that is not the case. The loans in question are granted with the distinct recognition that they are to be used for the purchasing and carrying of stocks.

Theory on Which Call Loans Are Made

§3. In the ordinary commercial loan, the security which protects the paper may be simply the signatures of the maker and acceptor or endorser. The real security in this case is the whole property and credit of the persons who are concerned in the transaction. The bank knows that the transaction grows out of a real piece of commercial business so that it is protected not only by the credit of the persons engaged, but also has in view a means of liquidation which will be supplied when the operation is finally closed. The call loan, if made from the speculative standpoint, has no such commercial basis, but is founded usually upon the opinion that the purchase which is undertaken is wise because of a probable increase in the price of the security purchased. This may or may not be warranted by facts, and the security may or may not be salable at a higher price in the future. In order to protect itself, therefore, the bank must refuse to make the loan as large as the transaction involved, and must limit itself to a specified percentage of the price of the security. This is presumably the valuation at which the security could be sold at practically any time, were it found necessary to get rid of it at a forced sale in order to provide means of satisfying the loan. On the assumption that the security is thus actually salable at practically any moment for some price, the bank makes a call or demand loan. This implies that if the bank wants to be paid, the person who has received the loan can dispose of his security which he has hypothecated with the bank as collateral and can with the funds pay off the institution which advanced them to him.

Call Loan Collateral Must Be Readily Salable

These assumptions are found to be erroneous under certain well

marked conditions. It is clear that the "securities" which are supposed to be used for the basis of speculation are simply investments; that is to say, they are capitalized incomes which are estimated on the basis of the past yield of given industries. The amount that will be given for them at any moment is regulated entirely by the supply of and demand for fluid funds seeking investment. If this is small, there is no reason why the price of the securities should not drop heavily as compared with the point they had reached when there was active demand. Moreover, the amount of fluid funds which can be used for such purposes may be greatly limited at certain times. If the banks all have extended considerable accommodation to persons desirous of buying the securities in question, and if those who sold the securities in the first place have taken the funds resulting from the sale and have wasted them or put them into fixed forms of capital, it may be very difficult for the holders of these securities to liquidate them at any given time should very many endeavor to do so. In such a case, a large flood of securities thrown upon the investment market would fail to find any immediate demand of similar amount. The result would be that prices would collapse, and holders of the securities would not be able to pay their obligations to the bank if they depended upon the proceeds of the sales of such collateral for means with which to do so. In that case, if the men to whom credit had been granted by the bank had no other property or resources, upon which the bank could fall back in its effort to collect, than the securities in question, the result would be that the bank must take over the securities itself and carry them on its books at a value equal to the amount of the loan, or else must write off a certain percentage of the amount lent as a loss on the transaction.

Difficulties Met In Liquidating Call Loan Collateral

Of course what would have happened in this case would have been the practical tying up of bank assets in a long-term investment. The bank which is obliged to take over stocks or bonds of a corporation is in exactly the same position as a bank which has lent funds upon real estate mortgage. The latter institution is likely to be the better off of the two, as the mortgage probably will not run for more than three years, while the bonds taken over may run for a much longer period, many of the issues on the market having a maturity of fifty years. As for stocks thus taken over, there is no definite date of maturity for them, so that in practice the bank can get its funds out of these forms of investment only by finding someone else who is willing to buy them. Thus a decidedly non-

Tying Up Bank Assets

banking transaction has been necessitated. The bank has purchased the long period securities and can relieve itself only by finding someone to accept the responsibility of purchasing them in its place. If it finds the investment market poor for a long period, this may prove to be out of the question, meanwhile. Under such circumstances, the call loan instead of being the most fluid type of banking accommodation, is the least so. In fact, its fluidity depends entirely upon the limited extent to which it has been made, and the attitude of the community toward speculation and investment. Neither of these conditions can be always exactly estimated by any bank. In a period of overspeculation and rising prices, there is grave danger that too large a proportion of bank loans may be on speculative securities. Then, when a reaction sets in, the funds of the community are found to have passed out of the control of the banks and into that of persons who are exploiting commercial and industrial opportunities.

Dangers of Overlending on Call

§4. It is not possible to ascertain with accuracy how extensive the call loans of the banks are at any given moment as compared with other types of loan. The following national bank returns furnish some information on the subject:

Extent of Call Loans

	On Demand, Paper With One or More Individual or Firm Names.	On Demand, Secured by Stocks, Bonds and Other Personal Securities.	On Time, Paper With Two or More Individual or Firm Names.	On Time, Single-Name Paper (One Person or Firm), Without Other Security.	On Time, Secured by Stocks, Bonds and Other Personal Securities, or Mortgages or Other Real Estate Security.	Total.
	Millions.	Millions.	Millions.	Millions.	Millions.	Millions.
Sept. 30, 1901.....	$211	$665	$1,087	$ 468	$ 586	$3,018
Sept. 15, 1902.....	237	706	1,176	517	642	3,280
Sept. 9, 1903.....	283	717	1,267	558	655	3,481
Sept. 6, 1904.....	279	818	1,316	611	699	3,726
Aug. 25, 1905.....	320	854	1,382	689	753	3,998
Sept. 4, 1906.....	374	828	1,502	776	818	4,299
Aug. 22, 1907.....	428	832	1,648	899	869	4,678
Sept. 23, 1908.....	395	922	1,582	852	997	4,750
Sept. 1, 1909.....	441	957	1,698	971	1,060	5,128
Sept. 1, 1910.....	524	939	1,842	1,068	1,093	5,467
June 7, 1911.....	529	953	1,885	1,124	1,117	5,610

A study of these figures shows that, on the average, about three-quarters of the loans of the national banks of the whole country are time loans, while one-quarter are call loans. Of the call loans, about two-thirds are on collateral security. But the call loan market must be studied in those cities where there are speculative markets, or

where the banks make a practice of making loans to borrowers engaged in stock-market operations in the financial centers. The largest call loan market is naturally in New York. The reports of the national banks in that city show that more than two-fifths of their loans are call loans, while less than three-fifths are time loans. Only a very small fraction of the New York call loans are not secured by collateral.

Approximately about one-sixth of the loans of all national banks are made by associations located in the city of New York, and the following statement shows the amount and character of such loans on comparable dates from 1905 to 1910, inclusive:

New York Bank Loans

Loans and Discounts.	Aug. 25, 1905. 42 Banks.	Sep. 4, 1906. 40 Banks.	Aug. 22, 1907. 38 Banks.
On demand, paper with one or more individual or firm names	$ 11,393,926	$ 10,676,198	$ 16,254,018.22
On demand, secured by stocks, bonds and other personal securities	385,652,014	292,251,532	251,867,157.84
On time, paper with two or more individual or firm names	135,669,910	137,991,340	161,108,403.21
On time, single-name paper (one person or firm), without other securities	115,961,886	111,172,734	130,477,323.47
On time, secured by stocks, bonds and other personal securities or on real estate mortgages or other liens on realty	156,987,276	149,959,233	152,414,155.99
Total	$805,665,012	$702,051,037	$712,121,058.73

Loans and Discounts.	Sep. 23, 1908. 37 Banks.	Sep. 1, 1909. 38 Banks.	Sep. 1, 1910 39 Banks.
On demand, paper with one or more individual or firm names	$ 6,800,529	$ 7,708,853	$ 9,948,094
On demand, secured by stocks, bonds and other personal securities	374,548,964	385,430,495	328,145,065
On time, paper with two or more individual or firm names	146,194,094	145,989,671	176,608,890
On time, single-name paper (one person or firm), without other securities	132,737,553	163,098,915	170,708,005
On time, secured by stocks, bonds and other personal securities, or on real estate mortgages or other liens on realty	245,372,335	223,425,689	188,470,806
Total	$905,653,475	$925,653,623	$873,880,860

It is probable that no such considerable supply of call loans could be furnished by the banks of the localities in which they are made if it were not for the coöperation of other banks. The call loans are rendered possible by the existence of quantities of idle funds and they therefore tend to be enlarged and developed at those points where idle funds are most abundant. This usually hap-

pens to be New York City because of the provisions of the national bank act which permit the redepositing of reserves and which thereby tend to consolidate the reserve money of the country in central reserve cities. There are three such cities, New York, Chicago, and St. Louis, and there is no apparent reason why the call loan business should not be highly developed in all of them, since all are subject to much the same conditions.

Source of Money For Call Loans

In the division of banking business, New York has tended more and more to become the headquarters for financial operations and the loans which are connected with them, while the other cities, particularly Chicago, have tended more largely to become the headquarters for industrial and commercial operations involving the necessity of aid on the part of banks. That being the case, the call loan market has its headquarters in New York City and much the larger proportion of this kind of business is done there. New York has become a speculative center. It has drawn the resources upon which it relies for abundant loanable funds of this kind from the smaller banks of the country which have redeposited with the New York institutions, while it has found these institutions looking more and more directly to it as a place where they could put their funds at interest during the periods when there was no demand for them at home. Depending as it does both upon the presence of large quantities of idle funds, and the existence of an opportunity for using these funds to profitable advantage in speculation, an ideal opportunity has been furnished by the speculative markets of New York, and banks have been able to take advantage of them while still keeping within the terms of the national banking act. At times it has become necessary for the government to attempt to check the tendency of the small banks to invest their spare funds in this way. This was notably the case before the panic of 1907 when the Treasury Department found that the deposits made by the government in small banks in the interior were being promptly transferred to New York banks, or were being placed with agents of one kind or another in New York that they might be lent on call at very high rates of interest.

Why New York Is the Speculating Center

Action Necessary In 1907 to Check Redeposit In New York

§5. The effect of this call loan market has been important in a number of ways. It has undoubtedly rendered possible the development of an extensive system of margin trading in stocks which would otherwise have found itself a good deal more hampered for funds. At those seasons of the year when interest has fallen to a

low level in New York owing to the inflow of funds from the country, bank loans have been abnormally cheap and available for the use of speculators. The speculators have under these conditions hastened to avail themselves of the opportunities held out to them by extending their transactions in stocks on margin. Brokers have obtained accommodation at the banks, putting up the securities themselves as collateral to protect the loans. Thus bank funds have become closely intertwined with the stock market, and bank condition has been made dependent in a certain way upon the level of prices on the exchanges. Conversely, stock exchange values have been made to depend upon the willingness of the banking and commercial public to supply the funds that could be used for speculation. All this has brought about a closeness of relationship between speculation and commercial banking which does not exist in foreign countries.

Development of Margin Trading

The situation is a peculiar outgrowth of the national banking system and its defective methods of controlling and regulating the extension of bank credit. This makes it important to consider both the attitude of foreign systems toward this peculiar type of loan and the question what should be done in the United States to eliminate the evils resulting from undue extension of such loans. So much attention has been focused upon the use of bank funds for speculative purposes and serious bank failures have so often been brought about by the participation of banks in speculative operations that there is a general, if ill-founded, fear on the part of many that any new legislation on banking is the outcome of efforts to obtain even more control over the fluid funds of the country that they may be used in speculation.

Speculative Use of Bank Funds Due to Defects In System

§6. So far is this assumption from being correct, that it is an unquestionable fact that the banks of the country, and especially those in New York, would greatly prefer not to loan their funds on call. We have seen how the call loan system comes into existence. If, in place of thus lending their funds, banks could be assured of a regular and steady market in which they could both dispose of such paper as they may need to realize upon, and at other times invest such funds as they may have to spare, they would seldom, if ever, make loans for purely speculative purposes. The reason why they now make such loans in so large a volume is, as indicated, that they are obliged under the national banking act to keep their so-called reserves within reach.

Banks Would Prefer Not to Lend on Call

This they cannot be sure of doing if the funds are tied up in time paper, because, in that event, they are dependent upon the other banks of the country for accommodation, and these other banks may or may not be willing to liquidate the paper in which the bank funds have been thus invested. If the other banks were always willing to convert paper held by banks which needed fluid funds into such funds, the banks would as soon have their resources invested in time paper as in call loans, provided that the rate of interest was as good in the one case as in the other.

Loans on Commercial Paper as Profitable as Call Loans

In the majority of cases the banks would find the rate of interest earned on commercial paper of the short period variety as good as or better than that earned on call loans. It would be only in moments of stress in the discount market that the speculator would stand ready to pay the exorbitant rates of interest that are occasionally offered for short periods in order to get the bank accommodation that is wanted. In other words, a discount market would cause a distinct shift in the use of bank funds.

Of course this does not mean that the establishment of a discount market would abolish the call loan. There is no reason why it should do that, and it would not be desirable to have such an end accomplished. There are many cases in which call loans are not made for speculative purposes. Frequently a man may have securities which he does not care to dispose of, but needing to realize a small portion of their value, he may go to a bank and ask for accommodation, offering the securities as collateral. In such a case, the bank may prefer to lend the money on demand both in order that it may not be troubled by the necessity of renewing the loan in case the borrower is not ready to pay back at the end of a stated period, and in order to call for more security at any moment in the event of a reduction in the market price of the collateral. This is a familiar type of trust company operation and will be likely to continue indefinitely. Moreover, there will always be banks and trust companies which devote themselves to financing trust company operations. Within proper limits, this kind of business is entirely legitimate and is open to no criticism whatever. The harm comes when the commercial funds of the country are used in speculation or in sustaining speculators' operations in the market. That simply means that under those conditions it is not possible for the commercial world to get back its reserves when it wants them and that consequently business has to wait upon speculation. It is this part of the call loan business now done that would be cut off, if the mar-

Harm Comes From Use of Bank Funds to Sustain Speculative Markets

ket for call loans were displaced and a discount market substituted in its stead as a field for its employment of commercial funds.

§7. The discount market to which reference has been made has been fully described and explained in the preceding chapter. At this point it is worth while to consider how the market would work in relation to speculation. Evidently two things would be required of such a market if it were to overcome the conditions that are complained of under the present system of call loans: (1) It would have to afford a satisfactory and adequate field of employment for the funds which now go into call loans, providing an equally available kind of resource; and (2) it would have to be of a character that would prevent the employment of its own funds in connection with speculation. That is to say, it would have to supply the banks on the one hand with the advantage they now realize from the call loan market, and on the other hand, it would have to transact its own business without falling back upon call loans.

How Discount Market Would Work

How far would these objects be accomplished? As for the absorption of the bank funds which are now thrown on the market at certain seasons and which afford the basis for call loans in speculative centers, it is clear that the whole question would be whether there was a demand for these funds in other parts of the country in connection with regular commercial operations there. If there were not this demand, there would not be any paper originating in commercial transactions into which the fluid funds could go. Now such a demand does exist. The operation of moving the crops does not occur simultaneously in all parts of the country, but the crop-moving seasons are seasons in the strict sense of the word and succeed one another at different dates. Moreover, it is a fact that manufacturing is active at periods that do not correspond to the growing seasons, while the same is true of importation in many lines of goods.

Demand for Commercial Loans Is Constant

While it is not possible to afford accurate statistics on such a subject, it is an undoubtedly safe generalization from experience, supported by the opinion of the most competent contemporary business men and experts, that the country's industrial efforts are so diversified as to furnish a very steady and constant supply of commercial paper. Assuming that to be true, what would happen would be that when banks had met the needs of their own customers fully during the growing season, they would transmit their funds to be used in the purchase of commercial paper origin-

ating elsewhere, in the assurance that they would be able to get their funds out of this paper on short notice if they desired. When a season that called for abundant fluid funds again presented itself, they would be able to dispose of the paper in the discount market to other banks which found themselves with a plethora of resources. Meanwhile, the banks which supplied the paper thus purchased would be banks which were feeling the full pressure of demand from local borrowers and which consequently had to get their resources from a distance, doing so in the case supposed, by selling their commercial paper and getting the proceeds.

§8. The discount market which has been described elsewhere was to be furnished by the creation of a reserve association representing the combined banks of the country as stockholders. The operation which we have just described might conceivably be performed without the aid of such an association but practically would be very much facilitated thereby. The Reserve Association would simply act as an intermediary between the banks in different parts of the country, receiving spare funds from some of them on deposit and accommodating others by rediscounting their paper. If credits with the Reserve Association were to be counted as reserves of the individual banks, as is proposed, the result would be still further to aid in making easy the movement of funds from one part of the country to another. Outside of and around the Reserve Association, however, there would ebb and flow a large volume of business based upon acceptances by the several banks. Such acceptances would be current all over the country, and inasmuch as they would be always rediscountable at the Reserve Association offices, they would be a very desirable form of investment for bank funds. Thus the Reserve Association would simply be the core of a large body of business done between the banks for the purpose of taking up the spare funds of some and supplying the others with these funds at times when they were hard pressed for the means of making loans.

How a Reserve Association Would Facilitate Sale of Commercial Paper

This same function is performed to some extent at the present time by the system of selling commercial paper through note brokers and otherwise all over the country. But this system works only in a partial and incomplete way, and does not supply the vital element that is needed—a medium of unquestionably salable paper in which the banks can invest with assurance that they can get their funds out again. To supply this assurance in positive terms

Note Brokers Now Perform This Function

there is necessary the presence of an institution dealing specifically in such paper and obligated to take it upon request provided it conforms to definite requirements laid down by statute.

This brings us to the other side of the question—whether the resources of the Reserve Association, and through it of the banks of the country, could be kept out of the speculative market. On this point, it ought to be sufficient to note that those who advocate the plan of a Reserve Association recognize the necessity of thus safeguarding the funds of the Association and to insist upon the necessity of keeping the resources of the Reserve Association out of the stock market.

There may be question as to the stringency of such a provision. Obviously the essential end of a Reserve Association like the one which has been proposed is to promote the solvency and security of the banks of the country. There may be times when such solvency and security would be furthered by granting relief to the possessors of sound collateral who were in need of loans. Others think that even if this necessity be recognized, the desirability of keeping the Reserve Association absolutely free from even the most remote connection with the stock market is such as to make it worth while to forbid in absolute terms the lending of funds upon collateral at any time. This is a question of judgment. It is, at all events, entirely possible by a rigid and exclusive limitation to put it out of the question that any funds whatever should be loaned by the Reserve Association on collateral security. This would mean that the institution would not deal in call loans at all. It would, in short, confine itself absolutely and wholly to the doing of a commercial business in the narrowest sense of the term, and its purchases of paper would be confined exclusively to the descriptions of paper and the kinds of business laid down in its charter. The question of seeing to it that the limitations of the charter were lived up to would be nothing more than a simple problem in bank inspection, the requirements of the law being easily enforced.

Different Views as to Loans on Stocks and Bonds

§9. What seems to be feared by some is that even though the requirements of the law creating the Reserve Association and of its charter, were technically lived up to, it might nevertheless be possible to get the use of the funds of the Association for speculative purposes by some other means. The statement is continually made that the "financial interests" of the country would seek to control the policy of the institution in their own favor. Granting

that there was no dishonesty and that infractions of the law and charter were not winked at, this could be done only by the presentation of paper of the kind specified to the institution. Only in that way could it be induced to make loans, since in no other way could it extend accommodation without doing violence to the terms on which it was allowed to exist.

This raises the question: Could speculators throw their transactions into such a form as to get the use of funds of the Reserve Association without asking for call loans? It is to be noted, first, that all business would have to be done with the Association through the agency of an existing bank. The question therefore is: Could a bank manage to get the funds of the Reserve Association by some transaction which did not involve a collateral loan and thus place them at the disposal of speculators?

Possibilities of Evading Reserve Association's Charter

It is, of course, clear that a bank might have in its portfolio a certain amount of live commercial paper and a certain number of loans made on collateral security. Now suppose that it desired to enlarge or extend its loans on collateral. It could take its live paper to the Reserve Association, get it rediscounted, and then use the proceeds in making more call loans on stocks. In that case all that would have happened would have been that the Reserve Association, representing the banks of the system, had taken the live part of the assets of this bank and had paid for them. There would be no result except that the bank thus disposing of its live commercial paper would speedily put itself into a position where it would have to go out of business. Customers of the commercial and mercantile kind would probably steer clear of it, while it would be unable to get further accommodation from the Reserve Association, inasmuch as it would thus be deprived of the kind of paper upon the strength of which it could provide itself with material for demanding rediscounts. In this case the result of the operations of the bank which sought to extend further accommodation to speculators would promptly be to cut it off from the commercial banking community, and thereby to eliminate the danger that the funds of the community would become more and more involved in supporting the stock market as they now are. The Reserve Association under these conditions would directly act as an agency for limiting the stock market phases of present-day banking.

One Method of Evasion

§10. The banks, however, would be their own protectors. It is not their interest to allow themselves to become involved in the

stock market, and at present it is only a very small percentage of banks that do actually become thus involved. When they do, it is necessary under our system to take care of them and prevent them from dragging down other banks into disaster. Under the proposed system a sharp line would be drawn between banks engaged in stock market operations and others. The former could not expect any assistance from the latter on the strength of the danger they offered to the commercial community. They would have to take the risk of their own operations themselves. In the event of danger, they could expect aid only from one another and from those banks which, although not directly involved, deemed it wise for reasons of their own to come to the aid of the institutions or corporations which had become entangled in stock market transactions. That there would always be some such banks there is no reason to doubt. The operations of the Reserve Association would tend simply toward the segregation of the strictly commercial banks of the community which would be federated together for their own protection through the working of the Reserve Association.

Banks Would Protect Themselves

Even if there were no restriction upon the operation of the Reserve Association, so that it could lend on stock market security if it desired, it is far from probable that the banks controlling it would permit any such use of its funds. United by a common interest, and looking to the Reserve Association as the source of relief for themselves, in case of necessity, they would recognize that every such loan made on stock market collateral would constitute a reduction of the loaning power of the Association upon other security; that is to say that it would constitute a direct reduction in the amount of accommodation they themselves could get. The only possible case in which it could be assumed that such transactions were likely to occur would be seen in an event where enough banks had become involved in stock market operations to influence the Reserve Association, against the judgment of its other members, to assist them out of their difficulties. No such case would ever occur for the reason that the vast majority of the banks of the country would not have funds tied up in the stock market or loaned on collateral. Self interest would prevent them from assenting to any such proposal. It may be said that in the past self-interest has worked in exactly the opposite direction. In periods of difficulty, clearing-house banks have united, sometimes, for the sake of supporting the very institutions which had fallen into difficulty by financing speculative transactions. That is true; but the case

Why Banks Would Guard Association's Loaning Power

would be quite different with a Reserve Association. In times past, the banks have aided those of their number which had become involved in speculation, because the failure of these banks would involve an attack upon their own solvency which they would have no means of resisting. An entirely different situation would exist if they could go to a strong central association for all the rediscounts they needed, provided they were equipped with the right kind of paper.

Fears Not Well Founded

There is no fear with reference to the working of a Reserve Association that may be more readily or certainly dismissed than the dread that the funds of the banks would, through such an association, be devoted to stock market speculation, or financial promotion schemes. Not only is the danger one that is perfectly easy to guard against by law, but, as has been shown, the whole purpose and working of the association would be to destroy the conditions which now operate to produce the danger contemplated.

CHAPTER VIII

THE INELASTICITY OF NOTE ISSUES

1. Why National Bank Notes Were First Issued—2. Foreign Systems of Note Issue—3. Motives for Note Issues—4. Working of National System—5. An Inelastic Currency System and Its Effects—6. Panic Conditions and "Emergency Currency"—7. Actual Note Issues—8. Relation of Notes to Bonds—9. Notes Limited by Cost of Bonds—10. Notes Not Quickly Obtained—11. Criticism of Conditions.

Why National Bank Notes Were First Issued

§1. One of the features of the national banking system which has been most widely subject to criticism is the method it provides for the issue of bank notes. A review of the history of the national banking system shows that the present method of securing the notes was adopted as a direct outgrowth of civil war conditions which had demanded the use of some method for assisting the sale of national bonds, and at the same time of furnishing a uniform national currency to take the place of the widely divergent, and often unsound, state bank notes. In consequence, the national banking act provided, as one of its salient features, for the issue of notes to be protected by deposits of United States bonds. These notes were to be supplied by the government Treasury as soon as the banks had handed over to the Treasury in trust a sum in bonds equal at least to a specified percentage of the capital of the bank itself. The turning over of the bonds was thus compulsory up to the specified percentage of capital (which differed as the size of the banks varied), while it was voluntary beyond that point and up to an amount equal to the face of the bank's capital. The banks, however, could not obtain an amount of notes more than equal to 90 per cent of the sum of bonds which they deposited. This therefore implied that they could not issue notes in excess of 90 per cent of their capitalization. The latter provision was subsequently altered (Act of March 14, 1900), and to-day national banks can take out notes equal in amount to the face of the bonds they

deposit, such bonds not exceeding in par value the capitalization of the depositing bank. This therefore makes a rigid limitation upon the issues of notes, but at the same time, presumably protects the note holder against loss through the failure of banks.

§2. A glance over the systems of note issue in vogue in foreign countries shows none where the plan followed in the United States is pursued. Japan, when preparing to introduce western civilization, adopted our note-issue method, but discarded it at about the same time that she gave up the obsolete type of battleship. Other countries have never seriously considered anything of the sort. Their systems are either those in which the notes are issued on the same basis as that on which bank credits are created, being subject to no restriction, or else they are protected by some special requirements as to the character of the assets behind the notes, or occasionally through the establishment of a guaranty fund contributed by all the banks, or in some similar manner.

Foreign Systems of Note Issue

The national banking system stands entirely alone in respect to its methods of providing for note issue. Inasmuch as it does thus stand alone, conclusions with respect to the working of the system of note issue provided by it cannot be compared with parallel inferences based upon the experience of foreign countries, but must rest upon their own foundation. In the main the situation under the national banking system has, however, been clear and easy to trace, and there need be no doubt about the principal defects and merits of its note issue system.

The chief field of discussion is opened when the question is raised whether such defects as there are in the system of note issue are responsible for the shortcomings of the national banking system as a whole, or whether they are to be regarded as merely an element in a general problem. It is the present view that the latter is the case. Fundamentally, there is no theoretical distinction between the bank note and the credit deposit. A borrower at a bank secures a loan or discount. Then the question in what form the funds are to be supplied must be met. He may arrange to get them either in the shape of an issue of notes or in that of a book account. Which he will ask for depends entirely upon the character of the means of payment which he desires to use, and there is no reason to suppose that the effect upon the bank due to the issue of bank notes will be different from that arising from the granting of a deposit credit. In either case the action of the bank creates a de-

Note Issue One Feature of General Problem

Bank Notes and Credit Deposits Compared

mand liability against which it must keep a reserve, and for which it must provide in other ways.

While this is the case in theory, there are practical differences of detail between the working of loans made through the issue of notes and those made through the granting of credit deposits. These differences are due primarily to the greater or less length of time for which the notes or deposits are kept outstanding without being cancelled. They are also due to the differences, so far as any exist, between the habits and practices of those who prefer notes and of those who prefer deposit accounts. It has come about that the bank note is more largely used in the rural districts, while the deposit account is more largely used in the cities. The note-holder in ordinary times is inclined to hold his note longer without asking for redemption or requiring any transfer on the books of the bank than is the depositor. These differences in practice give rise to a necessity for different classes of safeguards and different methods of protecting the various kinds of liability.

Motives For Note Issues

§3. It is clear that the motive governing note issues is the same as the motive governing deposit credits. This motive in either case is simply the desire to make a profit. The banker wishes to grant accommodation upon such security as may be offered to him, provided he considers this security sufficiently liquid and adequately protective, so that he can afford to make the loan. On the other hand, the borrower wishes to get his loan in order that he may use it in meeting his obligations and presumably in earning a profit. Anything that is done, therefore, to diminish the motive which leads to the issue of notes will alter the conditions of their issue.

In considering the bond deposit system, the important question is whether this system has tended to alter the circumstances under which the notes get out into circulation and are returned to the banks for redemption. It is evident that unless the purchase of the bonds results in bringing to the bank as great a profit as that which it could get without them, it will prefer not to issue the notes but to employ its funds in sustaining loans that take the form of deposit credits. Likewise if the use of the bonds results in bringing to the bank a greater profit than it could otherwise get, it will seek to force notes out into circulation as long as it can, since it will prefer to make its loans in that form rather than that of deposit credit. Conversely if the note-holder finds that notes are

more expensive for his use than other forms of bank accommodation, he will, where possible, take his loans in the cheaper form. Moreover, wherever he is assured, through bond deposit requirements, that the notes are guaranteed by the government, practically speaking, he will be much less desirous of demanding their redemption than he otherwise would be.

§4. In the national system all these factors have been seen in operation. Practically, it is not true that banks are in the habit of making a distinction to borrowers between loans that are granted through the issue of notes, and those that are granted through the establishment of credit deposits. The straightforward banker will treat his customers alike. But in those parts of the country where notes are predominantly called for, banks charge a higher rate of interest, while in those where the credit deposit is used, they are able to grant accommodations more cheaply. Again under the national system the tendency has been at times to curtail note issues to an unreasonable degree because the bonds were very costly. During the later years before the bonds issued to meet the cost of the civil war were refunded, and while the securities were still yielding five and six per cent, a very high premium was paid in the market for bonds. Inasmuch as the banks could not get any notes corresponding to the amount of the premium, the difference between a sum equal to 90 per cent of the face value of the bonds and the actual market price represented funds tied up and unproductive. By spending, say, $140 for a six per cent bond of face value of $100, the banks could get only $90 of notes. There was therefore a strong tendency toward contraction. In some recent years when money has been abnormally "easy," and when, therefore, there was little or no inducement to the use of bank resources in a thorough way for the purpose of maintaining as large a volume of commercial discounts as was possible, there has been a tendency for banks to make little or no effort to draw in their outstanding issues. They have always been able to curtail when they chose under the provision of law which allowed them to deposit lawful money with the Treasury to an amount equal to the sum they desired to withdraw, thus placing upon the Treasury the burden of redemption to that extent and relieving themselves of an equal amount of future responsibility. When they had no urgent need for their funds in other directions, they have not practiced this method of curtailing circulation but have allowed notes to re-

Working of National System

Influence of the Price of Bonds

main outstanding as long as holders chose to keep them out. The latter, on the other hand, have not been eager to secure redemptions, but have left it to the banks themselves to present one another's notes for that purpose. There has been very little real activity of redemption, the banks seldom presenting notes direct to one another, and only occasionally sending them to the Treasury for conversion into legal tender money. By this roundabout method of redemption, it has been brought to pass that the average life of the bank note under the national system is on the average some two years, as against the 30 days which is the average life of the Scotch bank note under the active system of redemption applied to their issues.

An Inelastic Currency System and its Effects

§5. This is what is called an inelastic currency—that is to say, one which neither expands nor contracts with direct reference to the increasing and decreasing needs of business. The national bank currency has been enlarged in those years and at those times when there was a sudden urgent demand for notes. Having been expanded on those occasions, it has been hard to force the notes in again. They have tended to remain in circulation, often in excessive amounts. Being thus a semi-permanent part of the currency system, they have tended to displace gold and have undoubtedly occupied a place which would otherwise have been filled by gold or its representatives. In this way, the bank notes have practically operated to prevent the banks from realizing any advantage through the exercise of the note-issue function. They have remained outstanding, in amounts which fluctuated but little and which were frequently near the upper permitted limit of the volume of notes that any given bank could issue.

When times of very urgent stress have come, the banks have not been able to meet their customers' wishes by taking out more notes, since in many instances they already had outstanding all that they could successfully care for. The result has been that they could get notes under such conditions only by borrowing them from other banks which had not fully exercised the note-issuing power. Frequently the Treasury Department has found its general fund clogged with bank notes to such an extent as to render its available gold resources dangerously small, pending the time that it could send the notes home for redemption. In those cases where the notes in the general fund were issues against which lawful money had already been deposited but which had not actually been re-

deemed, the case was even worse. Altogether the bond deposit system, by making the currency inelastic, has tended to prevent the extension of credits in this form when they were wanted.

§6. Much has been made of the failure of the national bank notes to expand in times of panic and of the fact that under such conditions the lack of an "emergency currency" rendered it necessary to resort to the issue of clearing-house certificates in order to supply the place which should have been taken by bank notes under a properly organized system. As will be seen at a later point, this is a misconception of the problem which offers itself at a time of bank panic, and the difficulties of such a period cannot be met by merely issuing notes, because the notes are liabilities with banks just as are their deposits.

Panic Conditions and "Emergency Currency"

It is true that at times of panic the defects of the system have been more obvious than at other times, because on such occasions there has frequently been a tendency to hoard money and thereby a shortage of currency has been produced which led to a demand for bank notes to fill the gap. This is a condition which has no necessary connection with the issue of notes as a means of relief from panic. It does, however, present a condition in which very useful service can be done by the banks, if they are in position to supply the convenience of the public by furnishing a form of currency to fill the void occasioned by the withdrawal of lawful money through unreasonable hoarding. A serious criticism has therefore legitimately been made upon the national banking system because of its incapacity to perform the primary purpose of a note-issue system—that of aiding the public in the transaction of its necessary daily business.

Panics Emphasize Defects In the System

It is probable that the evils experienced from this unsatisfactory bank currency in periods of panic are not nearly as great as those which result from the unsatisfactory working of the system year in and year out. Nor would the evils of panic periods have been so serious, had the gold stock not been partially displaced by the presence of a body of unredeemed and inelastic bank notes in the currency system of the country. With this outline of the conditions generally produced in the national system by the retention of a method of note issue which was the product of civil war financiering, we may now pass to a discussion of the details which have surrounded the national bank currency in actual practice.

§7. The actual note issues that have been taken out and redeemed by the combined banks of the United States during the years since 1900 are reviewed in the following table:

Note Issues Show Lack of Elasticity

NATIONAL BANK NOTES

1900—Issued*	$2,374,385,935	1906—Issued	3,566,012,225
Redeemed*	2,042,805,752	Redeemed	2,982,955,511
Outstanding	331,580,183	Outstanding	583,056,714
1901—Issued	2,497,486,135	1907—Issued	3,802,131,965
Redeemed	2,137,687,735	Redeemed	3,192,268,549
Outstanding	359,798,400	Outstanding	609,863,416
1902—Issued	2,630,795,575	1908—Issued	4,169,149,705
Redeemed	2,250,432,897	Redeemed	3,503,423,505
Outstanding	380,362,678	Outstanding	665,726,200
1903—Issued	2,818,044,835	1909—Issued	4,582,302,215
Redeemed	2,398,547,869	Redeemed	3,878,482,225
Outstanding	419,496,966	Outstanding	703,819,990
1904—Issued	3,031,506,945	1910—Issued	5,000,244,105
Redeemed	2,574,338,867	Redeemed	4,270,992,050
Outstanding	457,168,078	Outstanding	729,252,055
1905—Issued	3,304,097,735		
Redeemed	2,779,703,890		
Outstanding	524,393,845		

*Since the beginning of the system.

The figures indicate primarily the extreme slowness of redemptions under the national system. Although there has been a steady upward tendency in the amount of notes, resulting sometimes in inflation, the conditions of note issue have not been such as to produce any genuine elasticity in the currency. By elasticity, as has already been seen, is meant the changing of the amount of notes in circulation from time to time to correspond with the changing demands of business. If the currency of the United States were elastic, there would be what is called a seasonal variation in its amount. It would increase with the growth of demand in the spring and autumn and would decrease as this demand fell off.

Comparison with Canada

How a truly elastic currency expands and contracts may be seen by comparing the figures showing changes in the note issues of the United States with corresponding figures for the banking system of Canada. In the following table is reviewed the note issue situation in the Dominion during some recent years:

1900.		1901.	
January	$41,320,083	January	$45,025,306
February	41,699,231	February	45,905,942
March	43,814,918	March	47,611,967
April	43,908,432	April	47,006,701
May	42,856,762	May	46,148,234
June	45,577,387	June	49,119,479
July	46,007,906	July	48,947,978
August	47,421,277	August	51,352,309
September	50,387,070	September	56,027,407
October	53,198,777	October	57,954,779
November	51,947,269	November	57,741,566
December	50,758,246	December	54,372,788

1902.	
January	$48,586,529
February	49,450,934
March	52,442,982
April	50,691,588
May	50,754,716
June	53,953,043
July	52,070,065
August	55,035,701
September	60,965,801
October	65,928,973
November	64,497,641
December	60,574,144
1903.	
January	$55,040,987
February	55,746,498
March	58,283,484
April	55,877,647
May	56,949,119
June	58,865,845
July	57,563,665
August	60,414,740
September	63,741,270
October	70,480,611
November	67,425,586
December	62,539,407
1904.	
January	$56,973,273
February	57,736,243
March	59,760,119
April	58,649,870
May	57,857,174
June	60,098,480
July	59,979,830
August	60,227,074
September	63,795,962
October	72,226,306
November	69,426,931
December	64,507,394
1905.	
January	$58,021,075
February	58,828,919
March	58,721,173
April	59,941,648
May	58,136,070
June	61,587,560
1905	
July	61,277,593
August	62,497,433
September	69,831,259
October	76,890,863
November	72,592,543
December	69,981,574
1906.	
January	$60,936,610
February	62,434,893
March	65,991,818
April	66,530,677
May	64,217,332
June	69,366,505
July	68,182,979
August	70,108,511
September	77,209,346
October	83,718,630
November	80,502,357
December	78,416,780
1907.	
January	$68,219,717
February	70,547,759
March	76,346,013
April	72,840,909
May	70,741,113
June	75,510,402
July	72,942,781
August	76,562,811
September	79,455,000
October	84,289,983
November	84,452,899
December	77,504,398
1908.	
January	$66,871,378
February	68,548,075
March	69,047,892
April	66,712,899
May	67,770,018
June	68,153,994
July	66,697,255
August	70,389,897
September	76,246,237
October	83,036,762
November	80,287,734
December	73,058,234

With this should be contrasted the note issues of the national banks by months during the same period:

	Total National Bank Notes Outstanding.
1900.	
January	$246,277,222
February	247,068,742
March	249,516,227
April	271,034,337
May	285,359,366
June	300,569,758
July	309,640,443
August	320,095,890
September	324,304,325
October	328,416,427
November	331,693,412
December	332,292,300
1901.	
January	$340,141,174
February	346,821,871
March	348,655,255
April	350,101,405
May	350,764,257
June	351,582,589
July	353,742,186
August	356,152,903
September	357,419,155
October	358,830,547
November	359,911,683
December	359,720,711
1902.	
January	$360,289,726
February	359,444,615
March	358,434,867
April	357,476,407
May	356,987,399
June	356,747,184
July	356,672,091
August	358,984,183
September	361,282,691
October	366,993,598
November	380,476,334
December	384,854,514
1903	
January	$384,929,784
February	383,973,546
March	382,798,845
April	382,519,258
May	391,151,727

	Total National Bank Notes Outstanding.
1903	
June	406,443,205
July	413,670,650
August	417,346,487
September	418,587,974
October	420,426,534
November	419,610,683
December	421,106,979
1904.	
January	$425,163,018
February	426,857,627
March	430,324,310
April	434,909,942
May	437,080,573
June	445,988,564
July	449,235,094
August	450,206,888
September	452,516,773
October	456,079,408
November	457,281,500
December	460,679,075
1905.	
January	$464,794,156
February	467,422,853
March	469,203,840
April	475,948,944
May	481,244,945
June	488,327,516
July	495,719,806
August	503,971,395
September	512,220,367
October	516,352,240
November	524,508,249
December	533,329,258
1906.	
January	$540,914,347
February	543,230,080
March	550,803,895
April	554,666,967
May	556,646,281
June	559,129,660
July	561,112,360
August	561,481,045
September	569,852,303
October	573,903,108
November	583,171,985
December	593,380,549
1907.	
January	$596,162,469
February	596,197,569
March	596,343,022
April	597,212,062
May	599,913,840
June	601,940,549
July	603,788,690
August	603,395,886
September	604,056,321
October	603,987,114
November	609,980,466
December	656,218,196
1908.	
January	$690,130,895
February	695,402,762
March	695,674,519
April	696,407,355
May	697,645,698
June	698,449,517
July	698,333,917
August	692,088,991
September	685,326,103
October	675,612,327
November	665,844,987
December	667,178,177
1909.	
January	$677,068,165
February	676,673,092
March	678,285,600
April	684,407,615
May	687,408,227
June	688,183,115
July	689,920,074
August	695,354,164
September	698,845,474
October	702,807,459
November	703,940,557
December	707,433,457
1910	
January	$708,192,111
February	709,879,333
March	710,022,868
April	712,226,833
May	713,461,586
June	712,242,841
July	713,430,733
August	712,029,468
September	717,321,051
October	720,795,606
November	724,874,308

From the showing thus made it is clear that a very important distinction is to be recognized between the course followed by national banks of the United States and those of Canada. This difference is found in what is called the seasonal variation. In countries whose agricultural and industrial systems are organized as are those of the United States and Canada, the demand for note currency varies a good deal with the season of the year. In the spring and autumn, there are ordinarily periods of largely increased demand for currency which should be met by enlarged note issues followed by corresponding shrinkage when the demand for the notes is past. In every country with an elastic bank currency, this kind of seasonal variation or fluctuation occurs, the notes moving

Issues Do Not Follow the Demands of Business

in regular waves with high and low periods at corresponding seasons of the year. This is not the case in the United States, nor can it be so where bonds are used as a basis for the notes. Where they are so used, the conditions which control note issue and the amount kept outstanding are different from those which depend purely upon the current condition of business and upon its demands for accommodation. This lack of relation will be universally found wherever bank loans are taken in the form of notes.

§8. We have already noted the legal requirements which direct that no bank shall take out notes without having bonds of the national government to an equal amount for deposit at Washington as security. This, in itself, at once limits the gross amount of notes that can be issued to a sum equal to the gross total of bonds in existence. In practice, the amount which can be issued is much more limited, since not all national bonds that have been sold by the government are available for use by the banks in securing their currency. Considerable quantities of them are held by private individuals, or fiduciary concerns, as a means of investment. It has been an increasing practice in providing for the investment of certain classes of trust funds to require that they be used in the purchase of government bonds. Thus the amount of bonds available for use in protecting circulation is shrinking, and at times this reduction in the available amount has proved serious.

Relation of Notes to Bonds

Moreover, it has been the practice of the government under the act of June 3, 1864, to require that government bonds to an equal amount be deposited by the banks with the Treasury Department, whenever that department makes deposits of funds with the national banks (as it is permitted to by the law).* In times when a large Treasury surplus exists, the demand for bonds for this purpose is often great, and, in proportion as the bonds are thus taken up, the quantity available for use behind note-issues falls off. The Treasury is likely to be the custodian of large surplus revenues in periods of business prosperity when there is a strong demand for accommodation at the banks and incidentally for currency. These are precisely the occasions when national bank notes would probably increase if they were allowed to do so without artificial restriction. Yet these are also the occasions when the supply of bonds is limited by reason of their use as a protection for public deposits.

Bonds Used For Governme Deposits

* §5153 R. S.

Notes Limited by Supply of Bonds

After the panic of 1907, it was found that nearly all government bonds were deposited with the Treasury either behind notes or to secure deposits of public funds, and Congress then relaxed the requirements as to the kind of bonds to be held behind public deposits so as to permit the substitution of other securities in place of them. This, however, had already been done without express warrant by Secretaries of the Treasury from time to time, in order to release government bonds from behind public deposits that they might be used as a basis for the issue of bank notes. The fact remains that an effective limitation upon the amount of notes issued exists, and that this limitation has been important in the past and might become so at any time in the future.

In February, 1911, Congress passed an act permitting, for reasons which we shall consider elsewhere, the sale of new issues of United States bonds without the circulation privilege. Thus again the absolute limitation upon the amount of notes which can be issued on the strength of bonds is emphasized.

Notes Limited by Cost of Bonds

§9. The maximum limitation upon the quantity of the notes which could be issued in case of necessity is, however, unimportant as compared with the limitation which is afforded by the cost of the bonds and the other obstacles to their use as a basis for notes. United States two per cent bonds which are now outstanding to the extent of more than $730,000,000 constitute the principal class of security used to protect bank notes.[1] At present these bonds are selling at but little more than par, but there have been times (during 1902) when their value has risen as high as 108 or 109. In the event of a severe shortage of currency they would probably rise again to a considerable premium.[2]

[1]The bonds on deposit on November 1, 1911, to secure circulation were as follows:

Kinds of Bonds on Deposit.	Per Cent.	On Deposit to Secure Nat'l Bank Notes.	On Deposit to Secure Public Deposits.	National Bank Notes of Each Denomination Outstanding.	
U. S. Loan of 1925...	4	$ 22,854,300	$ 3,743,000	$ 1	$ 343,610
U. S. Loan of 1908-1918	3	18,199,380	4,199,300	2	164,320
U. S. Consols of 1930	2	593,006,600	15,478,900	5	145,500,120
U. S. Panama of 1936	2	51,760,300	2,132,500	10	325,160,210
U. S. Panama of 1938	2	28,349,740	712,000	20	220,696,580
U. S. Panama of 1961	3	.....	12,526,000	50	16,171,850
Philippine Loans.....	4	.....	4,717,000	100	35,996,600
Porto Rico Loans....	4	.....	754,000	500	90,000
District of Columbia.	3.65	.....	872,000	1,000	23,000
Territory of Hawaii..	Various	.....	685,000	Fractional parts..	49,608
Philippine Railway...	4	.....	146,000		
State, City and Railr'd.	Various	.....	2,618,000	Total....	$744,195,898
				Less.....	*5,030,585
Total		$714,170,320	$48,583,700		$739,165,313

[2]Report of Secretary of the Treasury, 1911, p. 5.

The three per cent bonds, even without the circulation privilege, command a premium of 2¼ per cent today, and such of the issues bearing a higher rate of interest as are still in circulation of course sell at an even higher rate. Whenever banks are obliged to purchase bonds in order to secure issues of currency thereon, they find the price of the bonds an important consideration. Under existing law the maximum amount of notes which can be issued on a bond of the par value of $1,000 is $1,000. Upon the sum which has to be invested in a bond bearing a premium, there is therefore a loss caused by locking up the premium. Thus, if the bond sells at 105, the bank which purchases it for deposit behind notes must pay $105 in lawful money of some kind, and will get in return only $100 of notes after it has deposited the bond with the Treasury. Moreover, such a transaction involves the bank in the necessity of investing at least $100 of its funds in a security which will yield it but 2 per cent on par, and even less on the real investment.

The practice in many cases is, of course, that of borrowing the bonds from those who own them, the owners in such cases being willing to lend them for use in this way in return for a consideration. The point is interesting as a matter of technical practice, but does not alter the real facts in the case. The amount which must be paid for the use of the bonds by the banks which borrow them is enough to put the institutions in as unfavorable a position as if they had purchased the securities at the outset.

Supposing that the bank is able to lend the notes thus taken out immediately, it will secure a return of but 2 per cent on $100 plus the going rate of interest—say 6 per cent—on the $100 of notes. From this earning it will have to deduct the cost of maintaining an adequate reserve of suitable amount behind the notes for their current redemption, the cost of depositing a 5 per cent redemption fund with the Treasury (keeping it idle and unproductive so long as the money is there held), and the cost of engraving and printing the notes, as well as the pro rata share of the expenses of operating the bank. Due to these conditions, banks find little profit in note issue at the present time. An estimate of the cost of note issue, ignoring the cost of reserve, is given as follows by the Comptroller:

Small Profit In Issuing Notes

Profit on National Bank Circulation, Rated on a Deposit of $100,000 United States Consols of 1930, Loan of 1925 and Panama Canal Loan, at the Average Net Price, Monthly, During the Year Ended October 31, 1910.-Panama Canal Loan of 1916-1936.*

1910.	Cost of Bonds.	Circulation Obtainable.	Interest on Bonds.	Receipts. Interest on Circulation at 6 Per Ct.	Gross Receipts.	Deductions. Tax.	Expenses.	Sinking Fund.	Total.	Net Receipts.	Interest on Cost of Bonds at 6 Per Ct.	Profit on Circulation in Excess of 6 Per Cent on the Investment. Amount.	Per.Ct.
January	$100,620	$100,000	$2,000	$6,000	$8,000	$500	$62.50	$9.66	$572.16	$7,427.84	$6,037.20	$1,390.64	1.382
February	100,656	100,000	2,000	6,000	8,000	500	62.50	10.28	572.78	7,427.22	6,039.36	1,387.86	1.379
March ..	100,182	100,000	2,000	6,000	8,000	500	62.50	2.87	565.37	7,434.63	6,010.92	1,423.71	1.421
April ...	100,687	100,000	2,000	6,000	8,000	500	62.50	10.90	573.40	7,426.60	6,041.22	1,385.38	1.376
May	100,687	100,000	2,000	6,000	8,000	500	62.50	10.97	573.47	7,426.53	6,041.22	1,385.31	1.376
June	100,687	100,000	2,000	6,000	8,000	500	62.50	11.04	573.54	7,426.46	6,041.22	1,385.24	1.376
July	100,687	100,000	2,000	6,000	8,000	500	62.50	11.11	573.61	7,426.39	6,041.22	1,385.17	1.376
August ..	100,905	100,000	2,000	6,000	8,000	500	62.50	14.73	577.23	7,422.77	6,054.30	1,368.47	1.356
Septemb'r	101,000	100,000	2,000	6,000	8,000	500	62.50	16.38	578.88	7,421.12	6,060.00	1,361.12	1.348
October .	100,920	100,000	2,000	6,000	8,000	500	62.50	15.17	577.67	7,422.33	6,055.20	1,367.13	1.355

*Here treated as maturing August 1, 1936.

[1]The act cutting off the circulation privilege from the 3 per cent Panama bonds was approved March 2, 1911, and was as follows:

"Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the secretary of the treasury be, and he is hereby, authorized to insert in the bonds to be issued by him under section thirty-nine of an Act entitled 'An Act to provide revenue, equalize duties and encourage the industries of the United States, and for other purposes,' approved August 5, 1909, a provision that such bonds shall not be receivable by the treasurer of the United States as security for the issue of circulating notes to national banks; and the bonds containing such provision shall not be receivable for that purpose."

It should be understood, however, that in thus computing the cost of getting out the notes only a very narrow method has been employed. Although the mode of computation of the profit on notes followed is that adopted by the Comptroller of the Currency, it remains true that this is not the way in which a banker should compute the cost of the bond deposit system as determining the amount of notes he could issue. The real cost to him of using his funds for the purchase of bonds, and thus for the getting out of the notes, is the amount of bank credit which he is obliged to forego by reason of the necessity he is under of getting out his notes in this way. As is well known, a bank is obliged to hold a given sum of reserve money as the basis for perhaps four or five times that amount of bank credit. That is to say, an institution which has $1,000 of gold can, if there is a demand for the funds, and if borrowers draw nothing from their accounts, make loans at the outside, to the extent of $4,000 or $5,000, giving the borrowers credit for that amount on its books. If the $1,000 must be used for the purpose of buying bonds upon which to base an issue of notes, its reserve is weakened to that extent. Even though it be released from the necessity of maintaining a reserve in the ordinary sense behind the notes, because of the fact that they are so fully protected by bonds, it still has to forego the genuine banking profit, which comes from the use of the money as a reserve basis to support loans of credit to customers. It is this which must be regarded as the true test, therefore, of the cost of note issues.

Bonds Limit Lending Power of a Bank

§10. One further phase of the inadequacy of the national bank circulation is seen in the extreme delay which is necessary in order to get out bank notes. Under the old system of bank-note issue, which prevailed prior to the passage of the Aldrich-Vreeland act (and which prevails to-day except in so far as special issues of notes have been provided for by that law), much time was required to secure an issue of bank currency. It was necessary to have an application for currency filed with the Comptroller, and then to have the currency printed, dried, and sent back to the bank, which in the meantime was obliged to get the bonds to deposit behind the new notes as security. This process requires at the narrowest computation 21 days, and where currency has to be shipped to distant points a much longer period is requisite. It is clear, then, that no speedy issue of notes can be hoped for even under

Notes Not Quickly Obtained

the supposition that the banks which desire to take out the notes have in their possession the bonds which are required for their protection. On the contrary, it is certain that under the most favorable circumstances three or four weeks must elapse before the notes can be issued.

The Aldrich-Vreeland law provided for the printing of $500,000,000 of emergency currency which is kept stored in Washington and could be issued without delay in the event of a call for it by banks. Banks, however, are not willing to pay the tax which the issue of this emergency currency necessitates and therefore they are still condemned to the long delay involved in getting out notes under the original note-issue provisions. Moreover, in most instances, the bonds are not in possession of the banks at the time when they want to take out the currency. They must buy them or, as is usually the case, must borrow them from others. If there is a shortage of bonds in the market this may cause a still longer delay.

Inelasticity of Bank Notes in 1907

The unfortunate effects of the inelasticity of the national bank currency are seen at their worst in times of panic and were probably never better exemplified than during the stringency of 1907 and the months succeeding it. Every effort was made during the latter part of 1907 to secure an expansion of the currency. The height of the crisis came late in October. In November, the increase was more than $46,000,000, while in December it was more than $33,000,000. This enlargement was brought about by very severe effort, and while some of it was obtained in time to grant a certain amount of relief from currency stringency, the bulk of it did not get out into circulation until too late to do much good. It would have been natural to expect that, because of this condition of affairs, there would have been a rapid retirement of such currency when the stringency was over. At such times, there is always a large shrinkage in commercial credits and the period after the panic of 1907 was no exception. This is seen by the fact that there was a decrease of 33 per cent in clearing-house exchanges for March, 1908, as compared with March, 1907; while for the first quarter of 1908 the clearing-house shrinkage was 28 per cent as compared with the preceding year. But at this time, when commercial credits were shrinking, national bank notes continued very redundant, actually growing by more than $8,000,000 during the first months of 1908.

The increase in notes was largely due to the organization of new banks and the issue of currency to institutions which had

applied for it, but had not obtained what they wanted during the actual stringency. These tendencies to increase should have been vastly more than offset by shrinkages due to the retirement of old bank notes or notes issued during the panic; but there was no such contraction. The currency continued upon an abnormal level for a great while. The difficulty with the national bank currency has been summed up by Mr. A. D. Noyes in the following manner:[1]

"The sum of the whole matter is that under the existing system of bank notes based upon government bonds, normal and authentic expansion and contraction of the currency, in response to needs of trade, is flatly impossible. The currency supply may be greatly enlarged in the dull midsummer months and suddenly contracted when the active autumn business season begins. It may increase rapidly at a time when trade reaction has reduced to a minimum the necessities for even the existing bank note supply, or it may be as rapidly reduced when large harvests, full employment of labor, and active hand-to-hand use of currency, most need a larger circulating medium. That there is no remedy for this abnormal situation, except the substitution of some other system for that which prescribes the United States Government bond as a basis for bank note issues, every economist at all familiar with the question agrees."

§11. The unsatisfactory character of the national bank-note currency has been one of the few things about the system that have been universally recognized and agreed to. There is hardly any support for the present system of issuing the currency. Even those who look upon it as having been heretofore a measurably successful experiment in note issue recognize that it is not possible to continue a system which would imply the existence of a national debt. While of course there is no positive assurance as to the future history of the debt of the United States, it is a fact that very large debt reductions have been made since the civil war, and that they may be hoped for in the future. It is also true that on not a few occasions when the debt might have been curtailed, Treasury authorities have stayed their hands because of a desire not to limit the basis of national bank currency in an undue degree. They have therefore opposed the purchase of bonds at times when funds were available for that purpose and might readily have been devoted to it.

Criticism of Conditions

Even if it were sure that the bonds would continue to exist in substantial amount, it would also be true that the problems connected with note issue have been found to be decidedly more seri-

[1]History of the National Bank Currency, p. 20, National Monetary Commission.

ous because of the operations on bonds growing out of the use of such securities as trust investments and the like. The problem of government deposits in banks has further tended to enhance the difficulty since it has appeared that the depositing of public funds upon a pledge of bonds exerted a strong constricting influence upon the currency at precisely the periods when expansion was wanted and vice versa. For these reasons even those who have been willing to accept theoretically the idea of bond security behind bank notes have not been willing to accept a basis which implied dependence upon government bonds under existing conditions.

Use of Other Than Government Bonds

This has raised the question whether it is not possible to retain a bond secured circulation by employing other classes of bonds as security behind the notes. The question was answered by Congress tentatively in the Aldrich-Vreeland law, which, besides a provision that notes might be issued under specified conditions by national currency associations, also contained a provision that notes might be issued direct to banks by the Treasury Department, provided that the banks would deposit with the Treasury other bonds of specified classes. Of course it was seen that this greatly increased the danger of issues of notes based upon bonds of an "outside" character. These issues would necessarily tend to displace gold, because they are not issued in response to business demand, but in order to earn profits from the investment in bonds which backed them, combined with the interest on the loans through which they were forced into circulation. Consequently the Aldrich-Vreeland law provided for a heavy tax on such note issues and a like provision has been carried in nearly every suggestion for banking reform that has been put forward within recent years.

Rapid Redemption of Notes Necessary to Safety

It has been seen that the question of redemption—rapid and thorough—or of some other means of insuring the retirement of the notes was a fundamental prerequisite if safety was to be in any way ensured. Consequently the proposal to retain the bond-secured basis for the currency by allowing the substitution of other bonds has received only a very qualified approval from those who were friendly to the general ideas of the national banking system.

The question has been greatly broadened by the decrease in the stress that competent students have been disposed to place upon the note question, owing to the more extensive study of banking problems that has been undertaken within recent years. There has been a tendency to consider the note-issue question as identical with

the question of other forms of bank credit and to endeavor to ascertain how such credit forms should be treated in order to secure proper assurance of safety, as well as proper redemption, contraction and expansion of notes along with other means of extending accommodation. Altogether the subject has lost the special character which it possessed as long as the national banking system was regarded as satisfactory in other particulars.

The note issue problem has now become a part of the general banking discussion. In popular talk about questions of currency and banking in general, however, there continues to be a good deal of over-emphasis upon the note question, and the fear is repeatedly expressed that if the exercise of the note issue function is not restricted in some exceptional way, what is called "inflation" will result. The problem of inflation is as serious in connection with other forms of bank credit as it is with notes. It is worthy, therefore, to be considered in a separate chapter.

CHAPTER IX

INFLATION AND OVER-EXPANSION

1. Fear of Inflation—2. How Inflation Is Revealed and Produced—3. Safeguards Regarding Investments and Redemption—4. Regarding Adequate Reserves—5. Limitation of Note Issues—6. The National Reserve Association and Inflation—7. Fear That the National Reserve Association Will Stimulate Inflation—8. Inflation, Theoretically Imaginable, But Not Possible.

Inflation and Over-expansion Used Synonymously

§1. In current discussions of banking, there is an almost invariable expression of fear lest any particular plan that is proposed may lead to what is called "over-expansion." This term is sometimes used interchangeably with the expression, "inflation." The two are practically synonymous as employed in current argument on the subject of banking, and there is general agreement that they constitute a serious menace to soundness in the management of any system which offers a field for them. It is, therefore, considered a test of any system of banking to ascertain whether it affords an undue opportunity for this expansion or inflation. In former chapters reference has been made to inflation in connection with note-currency, and it has been pointed out that the proper protection of the credit-granting operation avoids the danger of this over-expansion or inflation. It is now, however, necessary to explain in greater detail the methods by which such inflation is to be guarded against.

Inflation Revealed by the Condition of Banks

§2. Inflation or over-expansion is ordinarily revealed in the condition of banks. It exists in the case of an individual bank when, through loans, discounts or other investments, it has created against itself demand obligations in the form of book credits or notes which it is unable easily and readily to liquidate as the need for such liquidation appears. When such conditions are common to the banks of an entire community or country, there exists local or national inflation or over-expansion, a condition which is quite

certain to end in a crisis, or, at any rate, in prolonged business depression.

In order clearly to reveal the manner in which such conditions may be, and usually are, brought about, we must distinguish two functions of commercial banks and note the means available for performing them.

The most fundamental of these is their service as local, national and international bookkeepers in the current exchange of all kinds of goods and products. For such exchanges time is required and credit is often wanted to bridge over these time gaps. Thus, the farmer needs goods of various kinds during the period of the growth of the crops, by the sale of which he must pay for the goods; the manufacturer must buy raw materials, pay his workmen and meet various other expenses during the time required for the manufacture of the goods, by the sale of which he must ultimately pay these bills; the wholesaler must buy goods considerably in advance of the date of selling and receiving payment for them; and the same may be said of the retailer and of every link in our complicated chain of coöperative production.

Commercial Banks as National and International Bookkeepers

In the last analysis this function of commercial banks resolves itself into a process of bookkeeping by which the purchases and sales between the people of a given community, between those of different communities and between nations, are offset against each other in the form of debits and credits. Promissory notes, time bills of exchange, checks, drafts and bank notes, represent simply different steps in this process of bookkeeping.

Another function of banks is their service as intermediaries in the investment of capital. In this capacity they receive people's savings, which they credit as time deposits, and invest them directly or indirectly in the farms, factories, railroads and other industrial enterprises of the world, or in its homes, public buildings, wharves, etc.

Inflation Produced by Confusion of Commercial Paper and Investment Securities

It should be carefully noted that these two functions differ essentially and that a bank's means for performing them come from different sources. In the one case it is balancing on its books the current purchases and sales of its constituents; in the other, it is balancing their savings against permanent investments. Difficulty arises in the form of inflation or over-expansion when the latter business is confused with the former in such a manner that the banks overlook the fact that they cannot safely put into per-

manent investments more than the savings entrusted to them. If they exchange their own demand obligations against investment securities, there will be forthcoming no offsets, except the annual profits from the enterprises in which the investments were made, and it will take several years for such offsets to become complete. Meantime, they will be called upon to liquidate the credits they have granted and they will lack the necessary means.

In the performance of the function of balancing purchases against sales, inflation can only arise when the exchange machinery is not complete, or when it is out of order, or when the banks have miscalculated, or failed to note the proportion established by the habits of the community between the volume of transactions effected by means of cash and those effected by means of bank devices.

Importance of Perfect Clearing Arrangements and Adequate Reserves

In order that this balancing of purchases against sales may be complete, clearing arrangements must be established between the banks in all parts of the commercial world, which will work continuously and perfectly. To the extent that these arrangements are incomplete, or fail to work, banks are certain to be called upon to liquidate their demand obligations in money. The fact that not all purchases and sales are represented on the books of the banks, some being effected by means of money and credit supplied by other agencies, also renders this process of bookkeeping incomplete and subjects banks to demands for cash. It is at this point that the necessty for cash reserves becomes apparent; and then it becomes evident that a failure to maintain such reserves in proper volume results in inflation.

§3. In order to protect the community against inflation or over-expansion, therefore, safeguards must be devised to (1) prevent banks from tying up more than their savings deposits and their capital and surplus in investment securities and (2) to prevent their maintenance of inadequate reserves. Some of the means to these ends are direct and others are indirect in their operation.

Limitation of Loans as Investment Securities

The chief of the direct means is legislative regulation of the proportion of a bank's resources that may be loaned on investment securities and the enforcement of such laws by rigid systems of inspection and supervision. In the past, such legislation has been faulty and incomplete, partly because of the difficulty of setting up a practicable standard for distinguishing between commercial and investment securities, and partly, probably chiefly, because the importance of this distinction has not been understood.

As samples of the kind of legislation here under consideration may be cited the provisions of our national bank act and of many of our state banking acts prohibiting investments in real-estate and prohibiting, or limiting, investments on real-estate security as collateral. In France and Germany the statutes regulative of the Bank of France and the Imperial Bank, respectively, limit the bills which these banks may purchase to those which mature in not more than ninety days and which are secured by at least two names of solvent persons, and, in the case of the former bank, by an additional endorsement or by high-grade collateral. In the case of the Imperial Bank, the requirement is also made that the bank must hold enough of such bills to cover, together with its cash, the entire amount of its note issues and that the proportion of cash must not be less than 33⅓ per cent.

Illustration of Such Limitations

In our legislation no direct attempt has been made to draw a line between commercial and investment paper; but the French and German legislation aims to accomplish this end, the theory being that the great bulk of short-time paper is commercial. The only step beyond that taken by the German and French legislators that could probably effectively be taken by legislative bodies is the careful definition by statute of the two categories of paper and the fixing of the proportion of each kind that a bank might accept in accordance with the proportion between commercial and savings deposits, adding to the latter the bank's capital and surplus funds.

A Possible Step in Advance

The enforcement of such laws by inspection and supervision is difficult and can only be successful when backed by sound judgment, good will and good business methods on the part of bank officials. The organization of efficient credit departments in large banks and personal investigation by loaning officers of the use to be made of borrowed funds, backed by frequent consultation of up-to-date balance sheets in smaller banks, are essential.

Enforcement of Such Laws

Another direct means is the provision of as complete clearing arrangements as possible. Checks, drafts and bank notes are documents essential to the complete posting of the books by which these exchange processes are accomplished, and machinery must exist for securing the speedy recording on the books of banks of the debit and credit operations they represent.

For the clearing of checks and drafts elaborate machinery has been developed all over the world, mostly by the voluntary action of banks themselves. In this country clearing houses do the work

Clearing of Checks and Drafts

for the banks of the cities in which they are located, and, where clearing houses do not exist, daily clearings are effected by the direct exchange of checks between the banks themselves. Between different localities and between this and other countries, the work of clearing is accomplished by the correspondence system. In Europe the central banks with their branches play an important role, especially in inter-municipal and international clearing.

Clearing of Bank Notes

The clearing of bank notes is a more difficult problem. Being in form suitable for use as hand-to-hand currency, the public does not have the same motive for returning them to the banks as they do in the case of checks and drafts, and, when they are presented at any other than the bank of issue, the receiving bank does not always have a strong motive for presenting them for redemption to the issuing bank. Especially is this the case where the issue privilege is monopolized by a single bank and where other banks are permitted to count such notes as a part of their reserves.

Regarding this matter of the motive back of the presentation of notes for redemption, it should not be forgotten, however, that, so far as the public is concerned, in the United States at least, all forms of currency are constantly passing in and out of the banks. It is not the custom in this country for people to hoard money or to carry large amounts of it around on their persons. The desire of most people to avoid the danger of loss and theft, or to receive the interest everywhere paid on savings deposits, is sufficient in most cases to bring the money back to the banks in a comparatively short period of time.

Motives for the Presentation of Notes for Redemption

The case is somewhat different as regards the motive of a receiving bank in presenting for redemption the notes of another bank. Here the question is one primarily of the profitableness and the limitations on issues. If a bank has power to issue notes freely and finds it profitable and easy so to do, it will return for redemption the notes of other institutions and use its own in their place. The sluggishness of redemption under our national banking system is due chiefly to the very small profits that are obtainable through the issue of notes, to the difficulty of procuring bonds to deposit as security, and to the time and expense involved in our machinery of redemption. In the early history of New England, when her banks were issuing notes against commercial assets and the Suffolk system supplied easily accessible

and inexpensive machinery for redemption, bank notes were redeemed on the average about ten times a year.

When all note issues proceed from a single institution the redemption of notes is primarily a problem of reserves and of the exchange of one form of money for another. If the non-issuing banks are obliged to keep currency locked up in their vaults because they are compelled so to do by law, or because of the difficulty of obtaining it in time of need, bank notes are as likely to be kept under lock and key as any other form of currency, and so redemption will be sluggish. If, on the other hand, banks can easily and quickly secure currency by rediscounts, they will find it profitable to hold as "secondary" reserves interest-bearing rediscountable paper rather than currency, and the latter, including bank notes, will flow into the vaults of the reserve-holding institution or institutions.

Redemption When Issues Are Centralized

Another motive for redemption under a system of issue by a single institution is the desire to exchange one kind of currency or money for another. In Europe gold is commonly obtained for export or other purposes by the presentation of bank notes for redemption. This is an almost universal practice in England and it is common in Germany and France. It is sometimes interfered with in Germany by the inauguration of a restrictive policy by the Imperial Bank, and in France by the legal privilege enjoyed by the Bank of France of redeeming its notes in silver five franc pieces.

Desire to Exchange One Form of Currency for Another

The desire to exchange bank notes for other forms of currency is promoted by the issue of the notes in denominations too large for convenient use by the general public. In that case banks cannot use them as till money except in small quantities, and speedily send them in to the reserve-holding institution for credit or for exchange for currency of lower denominations.

§4. Other direct methods of guarding against inflation pertain to the maintenance of adequate reserves. In most countries this matter is left to the voluntary action of the banks themselves, the theory apparently being that their self-interest is a sufficiently strong motive to this end and that they alone have the knowledge and means necessary for a proper solution of the problem. In the United States we have attempted to secure this end by laws which fix a minimum below which banks are not permitted to allow their reserves to fall and prescribe the elements of which they must consist.

Reserves as a Check Against Inflation

In other portions of this book the evils and disadvantages of our system have been portrayed. Suffice it here to note what constitutes adequate reserves and what are the means available for their maintenance.

Reserves are adequate when they enable banks to meet all the demands for cash normally made upon them and likely to be made upon them on extraordinary occasions. The demands for cash normally and regularly made upon them are determined by the habits of their communities relative to the use of hand-to-hand money as distinguished from checks; and these habits are the result partly of tradition and long continued use and partly of the fact that for many purposes hand-to-hand money is more convenient than checks. These cash demands come from banks' regular customers in the form of the presentation of checks for encashment, and in the form of demands from other banks for the settlement of balances either through clearing-houses or by the direct presentation of claims. Their magnitude and fluctuations are made known to the banks by experience. There are, of course, irregularities which cannot be foreseen and which cannot be exactly calculated, but these usually form but a small percentage of the total.

What Constitutes Adequate Reserves

Extraordinary demands usually arise from the shattering of credit, from unforeseen changes in the volume of business transacted, from unusual events, such as wars, the payment of indemnities, etc., and in the United States also from the operations of our independent treasury system.

Demands for cash, whether ordinary or extraordinary, must be met by the gold and silver coin already in circulation, by the new supplies resulting from the output of gold and silver mines and brought to or purchased by mints, by notes supplied by governments, and by bank notes. In the case of the United States, some of these elements, especially government notes and silver coin, are limited in various ways by legislation, and losses or gains of specie may result from fluctuations in the balance between the imports and the exports of gold or other forms of money. These funds pass into the banks by the ordinary process of deposit, and, as has already been noted, the greater part of the supply is in an almost constant state of circulation through them.

Sources of Reserve Funds

There is no inherent difficulty in the banks securing an adequate supply of hand-to-hand money, provided the bank note element is based on commercial assets. In that case, if the re-

demption system hereinbefore discussed is complete and works perfectly, it will expand and contract automatically so as to render the entire volume of currency just sufficient to meet the needs. Difficulties in the maintenance of adequate reserves arise when such an elastic element is lacking, or when the clearing and redemption systems are inadequate, or when a country curtails its gold supply by a system of fiduciary currency which is purely local in its character and which is so large in volume as to leave too small a place for the local circulation of gold coin. In this latter event the banks may find difficulty in meeting their foreign balances, which, as a rule, are payable only in the yellow metal.

Causes of Difficulty in Maintaining Reserves

§5. As indirect methods of preventing inflation, may be mentioned various plans for the limitation of note issues. In the early history of state banking in this country previous to the Civil War, especially in New England, laws were enacted limiting the amount of notes that might be issued to some percentage of the capital, as, for example, 100, 125, or 150. The English Bank Act of 1844, usually known as the Peel Act, fixed an absolute limit beyond which the bank note element in the currency might not be expanded, by prescribing that after a date mentioned in the act private and joint stock banks might not under any circumstances increase their issues and the Bank of England might not increase its issues beyond £14,000,000, except in exchange for gold, pound for pound, or in substitution for the lapsed issues of other banks. In this latter case it could increase its issues by two-thirds of the amount lapsed, provided the Government, by resolution, should give it permission so to do. French law sets a limit beyond which the issues of the Bank of France may not go, but in the past it has raised the limit several times to meet the growing needs of the country for this kind of currency. Our National Banking Act limits the issues of national banks to the amount of the paid-up capital.

Limitation of Note Issues

This kind of legislation has usually been inspired by the hope and the expectation that the limitation of note issues would correspondingly limit the activities of banks and thus keep them within safe bounds. Sometimes also, especially in the case of the Peel Act, other theories and motives have been back of the legislation. It should be noted, however, that the mere limitation of the

Its Defects

amount of business a bank may do does not necessarily prevent inflation, because it does not insure its choice of the right kind of securities as investments, adequate redemption and clearing arrangements, or adequate reserves. Furthermore, the limitation of note issues only leaves the doors wide open for expansion through checking accounts and does not, therefore, nowadays seriously restrict a bank's operations. When the earliest of this kind of legislation was passed, however, deposit banking was in its infancy and limitations on note issues were much more effective than they are today.

Another method of restriction which has been favored by some reasoners and has found a place in certain banking systems is the imposition of a tax upon note issues beyond a certain point. Occasionally this tax is made progressive, rising as the amount of the notes increases and falling as it decreases, until at a designated point it is cut off entirely. The purpose of such a tax is to check the issue of notes and the corresponding granting of credits by making it unprofitable, or, in case the rate of interest is high enough to yield a profit in spite of the tax, to insure the speedy retirement of the notes and the contraction of the credits granted when the rate of interest falls.

Restriction of Note Issues by Tax

The tax idea has been adopted in the German banking system, which is probably its best known exemplification. In that country notes form the usual medium of exchange. It has, however, frequently been urged elsewhere and has been a favorite and staple recommendation in the United States as a means of limiting the over-issues of bank notes, even though checks drawn on deposits form the usual medium of exchange. In the Aldrich-Vreeland law, whose provisions have elsewhere been described, the tax plan is applied for the purpose of restricting the issue of "emergency currency" therein provided for. The terms of the original plan were so extreme in this regard that they provided for a tax running as high as 10 per cent per annum if the notes remained outstanding long enough. This, it is supposed, would tend to reduce the volume of the currency in circulation. By using the tax in conjunction with a reserve requirement, as is done in the German system, it is assumed that an even stronger safeguard is obtained. Thus, if the notes exceed a certain multiple of the amount of reserve on hand, they are to be subjected to a tax which increases as the relation to the reserve increases. In this event, the bank could cut off the tax in either of two ways—by retiring its

circulation or by building up its reserve so as to make it a larger percentage of the outstanding notes. The Aldrich-Vreeland law adopts the cruder plan of simply applying the tax in proportion to the time the notes stay out, without any reference to the question whether they are backed by an increasing amount of coin or not.

§6. In the plans for a National Reserve Association, suggested by the Monetary Commission, several provisions have a bearing on this matter of inflation or over-expansion. In the first place, it restricts the discounts of the proposed Association to commercial paper and thus strikes at the very heart of the problem. Its book credits are not to be protected by any kind of investment paper, and only that portion of its notes are to be so secured which are to be substituted for the present circulation of our national banks; and this condition will last only so long as the Government bonds, acquired in the process, are retained by the Association. As fast as it disposes of these bonds to the investing public, it will to some extent substitute commercial paper for them as a basis for its issues.

Restriction of Discounts to Commercial Paper.

Other provisions bearing upon this matter are those which constitute this Association the reserve-holding institution for the entire country. If the banks of the country generally take advantage of the privileges granted in these provisions, they will cease to hold more currency in their vaults than current demands upon them necessitate; and the currency of the country, including its bank notes, will circulate through the Reserve Association in the manner above indicated. Redemption of notes will thus be automatic and as regular and frequent as it is in France or Germany.

Centralization of Reserves

The only danger here lies in the possibility of hoarding by the people or by the banks. In that case, bank notes are as likely to be hoarded as any other form of currency, unless their denominations are so large as to render their use unlikely by people who are apt to hoard and so large as to supply to banks a motive for sending them in for exchange for other forms of money or for credit. Experience, therefore, may suggest the advisability of issuing most of the notes of the Association in relatively large denominations.

Possibility of Hoarding

Regarding the matter of hoarding, it may be said that there is nothing in the plan of the Association, or in its realization, to encourage such a practice. On the contrary, it offers many inducements of the opposite kind. It will increase the safety of banking

operations generally and thus the willingness of people to entrust their funds to banks, and it will remove from the latter the necessity of keeping currency locked up in their vaults as reserves and furnish them inducements to turn over to the Association their surplus supplies. If experience should show that these inducements need to be made stronger, the Association might agree to pay the expenses of return shipments of its notes.

It should be noted that the proposed National Reserve Association will not have the same motive for keeping its notes outstanding that a bank would have which is managed primarily for the earning of dividends for its stockholders. Restricted as it would be in the amount of dividends it can declare, its primary motive would be to keep the banking system of the country safe and strong and our currency in proper relation to our needs. In the matter of the return of its notes for redemption after the need for them had passed, its interests would be identical with those of the public.

Motive for Withdrawing Redundant Notes

The plan of the Monetary Commission, however, does not rely upon the self-interest of the Association as an inducement to seek the return of its notes. It provides an additional motive in the form of a progressive tax on the notes when they exceed $900,000,000, a sum less than $200,000,000 in excess of the amount of National bank notes now outstanding and probably no larger, if it is as large, as the country will need in the crop-moving season.

The Tax on Circulation

A further check against excessive issues is provided in the requirement that a reserve of 50 per cent of the amount of deposits and notes must be carried in legal tender money, or in lieu of such reserves, a heavy tax paid. Moreover, no more notes can be issued when the gold in the reserves falls below 33⅓ per cent of the note-issues. Hence, at that point, borrowing banks demanding notes would be refused loans.

A further check against inflation is provided in the increased facilities for clearing offered by the Reserve Association. The local associations are to be permitted to assume clearing functions, and, to the extent that they do, the time required for the collection of checks will be shortened and their return to the banks upon which they are drawn correspondingly hastened. Furthermore, the central office and the branches of the Reserve Association will constitute additional links in the national bookkeeping process, and will offset against each other on their books many of the mutual claims of banks which now remain unsettled for longer or shorter

Increased Facilities for Clearing

periods of time, and, when they are settled, occasion a considerable demand for cash.

In this connection should be considered other provisions which supply the Association with the means of replenishing its reserves, if the streams of money flowing into its vaults from regular sources should at any time be inadequate. These are the provisions which authorize the Association to deal in foreign bills of exchange purchased from other bankers or on foreign markets and to regulate its rate of discount according to its needs.

Means of Importing Gold

Both these provisions will enable the Association to bring gold into its vaults from foreign sources. When its reserves are large, it can purchase foreign bills, and it can sell them for gold when its supply of money is short. It will probably also be able to attract gold by raising its rate of discount. This will certainly be possible when the volume of bank acceptances becomes large and a regular market for them is established. European bankers will then invest in them, when the rates are higher than they are at home, just as they now do in London bills.

Still another feature of the proposed plan for a National Reserve Association deserves mention in connection with this subject of inflation, and that is the provision that it shall hold the deposits of the federal government. The operation of our independent treasury system at the present time is a source of embarrassment to banks because of the uncertainty of its drafts upon, and its contribution to, their reserves. By unexpectedly withdrawing reserves from the banks, it leaves them less able to meet their demand liabilities in cash. It is thus a cause of inflation, and its abolition, so far as concerns the holding of the treasury balances, will be a safeguard against this evil.

Abolition of the Independent Treasury System

Finally, and most important of all checks on over-expansion, there is the increasing rate of discount which the National Reserve Association would charge as its reserves decline. That is, any general tendency to apply to the National Reserve Association for loans would directly increase its immediate liabilities in its deposit or note items, and thus lower the percentage of cash reserves to these liabilities. Automatically the rate of discount to borrowing banks should rise, thus making it more expensive to carry the loan. Hence, there would be created a self-interest on the part of the borrower to pay off the loan. Moreover, no speculative accounts created for carrying goods which show a tendency to rising prices could endure the increasing rates of interest. The experience of

Raising the Discount Rate

Europe shows the influence of the rate of discount. In England, where conditions of banking more nearly resemble our own, the increase in the rate at the Bank of England at once drives away applications for loans, except where absolutely needed. Then, when the pressure for loans ceases, the rate of discount falls as a matter of course. Here, then, is the one most effective brake which the National Reserve Association would apply to prevent over-expansion. Taken in connection with the other preventives above mentioned there need be no fear of over-expansion, with ordinary intelligent management and courage. In recent proposals now before Congress it is not left to the will of the management to decide when the time has arrived to raise the rate. As soon as the reserves fall below 50 per cent of the notes and deposits a progressive tax is imposed, which is intended to force the National Reserve Association to reimburse itself by raising the rate to the borrower.

Most Effective Brake on Over-Expansion

In addition to this provision, the loans to any one subscribing bank should not exceed its capital; and none should make acceptances to exceed one-half its capital and surplus.

§7. In spite of those safeguards the fear has been expressed that the National Reserve Association will promote or stimulate inflation. Critics of the plan (of allowing the banks to count as reserves notes or credits obtained from the Association by rediscounting their commercial paper) argue that this easy way of increasing reserves would lead to an enormous inflation of loans. National bank loans are now about six times as large as the reserves, and it is argued that any increase in the reserves would result in an increase in loans in the same ratio. Banks, when loaned up to the limit, could rediscount commercial paper to the amount of their capital, and could then pyramid more loans on the basis of the notes or credits thus obtained from the Association. The operation would be accelerated, it is argued, because the proposed transfer to the Association of the greater part of the reserves now held by the banks would enable the Association to expand its liabilities to from two to three times the amount of the cash so received.

Contention of Those Who Foresee Inflation

The fear resulting from this argument is based upon the failure to distinguish, on the one hand, between the possible and the practicable expansion of loans; and, on the other, between the kind of loan expansion which results in inflation and that which does not so result. The above calculation measures the extent to

which the National Reserve Association *might possibly* increase accommodations to the commerce of the country, but it is no measure of the extent to which it would be practicable to increase loans under given conditions.

If the crops of the country and the output of our mines and factories and the incomes and corresponding consumption power of our people should increase in proper proportions to each other to such an extent that the increased volume of exchanges would require for their execution the degree of expansion of loans and deposits indicated in the above calculations, such expansion would take place; and it would carry with it no inflation and be in no sense dangerous, because in this increased volume of exchanges the purchases and sales would offset each other on the books of the banks just as readily and easily as would be the case in a smaller volume of exchanges. It is not the magnitude of the number of items in the debit and credit accounts of banks that is significant in this connection, but the balance between the two, and that balance may be just as readily struck when the number is large as when it is small. For instance, loans based on cotton evidenced by warehouse receipts could be increased in the autumn to a sum equal to the amount of the crop without resulting in expansion.

Fixing Relation Between Investment and Commercial Paper

As has been shown in previous paragraphs, the striking of the balance is the important thing, and to this end the primary consideration from the banking standpoint is the differentiation between commercial and savings deposits and the fixing of the relation between the amount of commercial and investment paper purchased in accordance with the proportion between their magnitudes, modified by the capital and surplus funds of the banks themselves.

But it may be asked, how can the banks be induced or compelled to observe such distinctions and to shape their practices accordingly? So far as supplying inducements is concerned, the National Reserve Association will be a mighty force. Since it will take commercial paper only and will create a national and international market for it, the banks will be obliged to make the distinction above mentioned and will have the strongest possible motive for shaping the practices of their customers accordingly. As an aid to this end they will be able to offer them the inducement of lower rates on such paper.

So far as compulsion is concerned, the necessity of constantly liquidating the book credits banks create will be quite adequate. If a bank makes the mistake of creating too great a volume of

credits against investment securities, it will find itself speedily checked up by adverse clearing-house balances and the presentation of checks for encashment, which demands it will find difficulty in meeting, even through access to the National Reserve Association, because of the very shortage of commercial paper which lies at the basis of the trouble.

The effective restraint of banks under such conditions will be accomplished by the clearing and redemption facilities before described. So long as the checks and sight drafts issued in these credit operations are speedily returned to the banks against which they are drawn and the notes issued by the National Reserve Association are constantly and regularly returned to it for redemption, there can be no inflation or over-expansion of loans. It is, therefore, with the perfection or imperfection of these features of the plan that the question of inflation is primarily connected.

Another phase of the inflation fear is presented in the charge that the notes of the National Reserve Association would displace large quantities of gold in our circulation and thus endanger the maintenance of our standard of value. This, like the other, may be shown to be groundless.

To the extent that the National Reserve Association assumes the issue privileges of the national banks, and as long as it retains the bonds purchased in the process, its notes will fill the place now occupied by the national bank notes, and will not in any respect change the existing relation between the gold and the fiduciary elements in our currency. The additional untaxed issues to be allowed will be no more than adequate to meet the increased currency demands of the crop-moving and spring-opening seasons and will be speedily retired by the process of redemption previously described when the need for them has passed. There is, therefore, no ground whatever for fear that they will displace gold. Indeed, they may occasion an increase in the gold supply, since the Association may find it necessary to secure the increased reserves required by the importation of gold. The reason why, under existing law, it may be charged that undesirable increases of national bank notes are driving out gold, is that there is no effective means of contracting these notes when once issued. An elastic note circulation which contracts when not needed would not drive out gold.

Charge That the Association's Notes Will Displace Gold

Conditions will not differ essentially if the Association should make use of its right further to extend its issues by the payment

of the tax prescribed. Such an issue would represent a greater or less degree of emergency, would be absorbed by the increased currency demand thus occasioned, and would be speedily retired when this demand disappears. Meantime, as in the previous case, the Association may have found it necessary to import gold as a means of increasing its reserves.

This fear is doubtless responsible for the suggestion that the National Reserve Association should not be permitted to count as reserves any form of money except gold. If, as above indicated, there is no danger of the displacement of gold by notes of the Association, there seems to be no good reason for placing this limitation upon it. There may be good grounds for the desire to increase our supply of gold, but there is no reason for shifting the responsibility for any shortage we may have from the Congress of the United States where it belongs. Indeed, if it is desirable to retain our greenbacks and to preserve, without change in the conditions of redemption, our silver coin and silver certificates, it is equally desirable that the National Reserve Association should be allowed to consider them as reserves. Any other arrangement would amount to a discrimination between the different elements of our currency, the exact parity between which the Secretary of the Treasury is obliged by law to maintain. If Congress is ready to acknowledge that such a discrimination should be made, it should proceed at once to the retirement of the greenbacks and to the reduction of our silver currency to a subsidiary basis. Under such conditions the reserves of the Association would consist exclusively of gold.

Should the Association's Reserve Consist Exclusively of Gold

§8. The question may be raised whether a borrowing bank should be permitted to count the notes of the National Reserve Association in its lawful reserve. It has been generally agreed that it should so count its credits on the books of the National Reserve Association. Then, why discriminate against the notes? The notes of the Issue Department of the Bank of England, as is well known, are counted in the reserve of the Banking Department. But the conditions there are not the same as here. Moreover, it may be urged that the borrowing bank, if allowed to hold the notes of the National Reserve Association in its reserve, would have no motive for sending them in for redemption, since they would be as good as gold; that the proceeds of one loan in the form of National Reserve Association notes could as reserves form the basis of addi-

tional loans by the subscribing bank from four to sixteen times as much more; and that in a period of 28 days a first loan might be made the occasion of a very dangerous pyramid of credit.

Theoretical Case of Pyramiding Loans.

For instance, a bank with a capital of $100,000 might get a rediscount of $30,000 for 28 days, and place $30,000 of National Reserve Association notes in its reserves. If obliged to keep 25 per cent reserves, the bank might, it is said, make new loans for $120,000. With the commercial paper thus obtained, the subscribing bank might get another rediscount for $70,000 more from the National Reserve Association, and add $70,000 more notes to its lawful reserves; and then be enabled to again increase its loans to its customers by perhaps $280,000. Thus, on an initial loan of $30,000, the subscribing bank might increase its loans by a total of $400,000. If its percentage of reserves were only 15, then the total would be much larger.

In such an instance as this, it should be noted that expansion is as possible with credit accounts on the books of the National Reserve Association, when the outcome of a loan, as it is with National Reserve Association notes. But, it is assumed that the credits would not be so expansible, since they must soon be liquidated by extinguishing a credit at the National Reserve Association when the loan is repaid. But we may take the case of the notes as the most extreme case.

Concrete Case as the Answer

What would be the restrictions on such pyramiding as is described above? (1) If a rediscount is made directly to the bank (and not guaranteed by the local association) the loan must be paid back within 28 days. (2) The subscribing bank, when expanding loans to its own customers must count upon these customers drawing down the amounts loaned them, perhaps by 75 per cent. If so, then customers to whom were loaned $400,000 would call for $300,000 of cash from the reserves (or checks from other banks would be presented to that amount at the clearing-house). But the bank would have had only $100,000 (equal to its capital) of National Reserve Association notes in its reserve. That is, the requirement of reserves (which would remain as now) would at once hobble the bank from any such pyramiding. In short, its lending power would be obviously limited, as explained earlier in this chapter. In the example given, the bank having received notes to the amount of its capital ($100,000) would probably not dare to grant loans on the basis of reserve (which it must give up in 28 days) of more than once or twice the amount of this reserve. If it

made loans of $200,000, and drafts were made by customers on their accounts to even 50 per cent, then all the National Reserve Association notes would be exhausted. To say nothing of strict surveillance by bank examinations, ordinary banking self-preservation would prevent such attempts at expansion. And what is true of National Reserve Association notes would also be true of credits on the books of the National Reserve Association. On the other hand, if the public already had circulation enough for its business habits, additional notes would not be drawn from the banks taken as a whole; and the new reserves would in truth carry a larger amount of loans than indicated.

If such operations were really to be feared, it might be possible entirely to prevent them by a provision forbidding any subscribing bank to hold more than (say) 10 per cent of its lawful reserves in notes of the National Reserve Association on an average during any one calendar month; but this provision is doubtless unnecessary.

In the whole matter of over-expansion, the crux of the question is due provision for elasticity of notes and credit. Elasticity in extending notes and credit in time of need must be always accompanied by proper regulations for their contraction when the need has passed by. The rising rate of discount is the practiced and proved instrument for bringing about contraction of credit when not needed. In the case of notes, provided immediate redemption by the National Reserve Association is secured, any surplus not needed by the public would be sent in for deposit or redemption; and the banks would have no reason for holding on to them, because if returned to the National Reserve Association, they would still form a credit on the books of that institution as reserves. The banks would retain them only to satisfy the calls of customers for cash when receipts of cash fell below demands.

Redemption of Notes.

More than that, a situation would be created by the National Reserve Association in which there is a premium on getting rid of notes of the Association and of any other forms of money. That is, the motive for carrying dead cash, which earns nothing, is taken away by the knowledge that liquid assets in the form of good commercial paper can at any moment be converted into bank reserves. If so, a bank will have a positive inducement to change dead cash in its assets to interest-bearing assets to the fullest possible extent. Thus, more of the bank's assets will be earning a return than ever before, and the reserves of the country will be economized with

Making Dead Cash a Live Asset.

safety. Under such conditions, there will exist a strong incentive to each subscribing bank to send in the notes of the National Reserve Association, and thus secure the quick redemption which is so necessary a part of elasticity of the circulation.

Quick Redemption Necessary to Elasticity

In addition, the banks in cities having a foreign trade and which may be called upon for gold for exports or other purposes would be led to present the notes of the National Reserve Association to be redeemed in gold. There would thus be another reason for driving in the notes for redemption. Obviously it would be well, for this reason, to issue a considerable portion of the notes of the Association in large denominations.

CHAPTER X

BOND-SECURED AND BANKING CURRENCY

1. Retiring the National Bank Notes—2. Refunding the Bonds—3. Other Plans for Using the Bonds—4. An Alternative Method and Objections to It—5. The Monetary Commission's Plan—6. Disposition of the Bonds—7. The Question of Monopoly—8. Use of Profits from Note Issues—9. Access to Notes—10. Security of the Notes.

§1. It may be agreed that the substitution of bank notes not based upon government bonds for the present bond-secured currency would be a very desirable change in present banking methods in the United States, and yet there may be very sharp disagreement as to what should take the place of such notes and how the various conditions connected with the problem of retirement should be dealt with. Naturally, a system of note issue which has been in operation for half a century, and around which many interests have been developed, cannot be easily broken off in favor of another. Numerous problems of detail require attention, equities must be recognized, and the operation, however beneficial in its main purpose, must be carried out in such a way as to cause as little friction during the transition as may be.

Retiring the National Bank Notes

Many plans for making the actual change from a bond-secured bank currency to one not so secured have been offered during the past two decades. In all of them, of course, there is fundamentally present the question, What would be the effect of such a change upon government bonds and their owners? As we have seen, the bond-secured currency was first resorted to in order to create a market for bonds. It ultimately succeeded in accomplishing this end. The chief effect of the artificial requirement that banks should invest in government bonds as a condition of their existence has been greatly to raise the price of the bonds themselves. The old 6 per cent and 4 per cent bonds commanded a very high premium, running as high as 40 per cent above par.

Changing the Bond Basis

In the act of March 14, 1900, the national debt was consolidated into a general 2 per cent loan, of which about $730,000,000

is now outstanding. Most of the other bonds, as they ran out, were converted into two per cents, and it was supposed that the twos would sell at about par. In fact, they sold at a premium of as high as 8 per cent within a year after the first issue was put out.

Decline in the Price of Bonds

In recent years prices of all bonds have tended to decline and the twos have gone down as others have, reaching a general level of about 101. Of the $730,000,000 outstanding, not less than $690,000,000 are held by banks for the purpose of protecting government deposits or issues of currency. This means that the loss due to the depreciation of the bonds has fallen in very large measure upon the banks. The total amount of such loss is estimated by the Comptroller of the Currency at probably about $30,000,000—a loss which has been simply "written off" by the banks on their books.

In spite of this reduction in price, it remains true that the bonds are very far above their natural value. This is shown in several ways. Sales of short time bonds bearing 3 per cent interest and not available for circulation purposes brought only about par in 1907. The postal savings bonds recently placed on the market, which bore 2½ per cent interest and could not be used to protect circulation, have sold at 92½. Comparisons of our borrowing power with that of foreign countries confirm the belief that our bonds are not entitled to anything like their present price on an investment basis. This idea is fully borne out by the table lately compiled in the Treasury Department. (See next page.)

Price Above the Natural Value of Bonds

The influence which has maintained the value of the 2 per cent bonds has been the fact that they could be used behind circulation. If that were removed, they would undoubtedly fall to a point somewhere between 80 and 85. The banks which hold them would thus lose 15 or 20 per cent of the par value of the bonds.

It would be an impossible and unfair suggestion to secure the alteration of present methods of issuing currency by any plan which would impose on the banks so heavy a loss as would thus be necessitated. The banks took the bonds in good faith and with the circulation privilege as one element in their value. To strip the bonds of this privilege would be equivalent to taking away one of the favorable terms and conditions upon which they were disposed of at the time when the banks took them over. This would be practically equivalent to the repudiation of a part of the value of the bonds, that is to say, a part of the debt of the government. As such it is not to be thought of. Neither from the standpoint of equity, nor from that of political expediency and possibility, nor

Summary Change Would Cause Large Loss to Banks

PRICES OF FOREIGN BONDS

AVERAGE ANNUAL NET PRICE OF GOVERNMENT BONDS OF ENGLAND, FRANCE, GERMANY AND UNITED STATES, 1878-1909.

The quotations for English consols, French rentes and German imperial loans from 1878 to 1907 are taken from the "Materialien zur Beurteilung der Zusammenhänge zwischen dem öffentlichen Schuldenwesen und dem Kapitalmarkte," Berlin, 1908.
The quotations for United States bonds were compiled by the United States Treasury Department.

	English Consols.			French Rente, 3		German Imperial Loans.			United States Bonds.		
Year	3 Per Ct.	2¾ Per Ct.	2½ Per Ct.	Per Ct.	4 Per Ct.	3½ Per Ct.	3 Per Ct.	4 Per Ct. of 1907.	4 Per Ct. of 1925.	2 Per Ct. of 1930.	3 Per Ct. of 1908-1918.
1878.....	94.44	.....	.....	74.23	95.72	.....	.....	100.67	.....	.....	.....
1879.....	96.75	.....	.....	79.64	97.89	.....	.....	100.60	.....	.....	.....
1880.....	97.62	.....	.....	83.16	99.89	.....	.....	106.32	.....	.....	.....
1881.....	99.25	.....	.....	83.80	101.46	.....	.....	115.37	.....	.....	.....
1882.....	99.75	.....	.....	81.24	101.53	.....	.....	119.26	.....	.....	.....
1883.....	100.44	.....	.....	78.02	102.09	.....	.....	119.84	.....	.....	.....
1884.....	100.25	.....	.....	76.81	103.13	.....	.....	121.55	.....	.....	.....
1885.....	98.58	.....	.....	79.19	104.25	.....	.....	122.28	.....	.....	.....
1886.....	100.05	.....	.....	81.23	105.99	102.88	.....	126.21	.....	.....	.....
1887.....	101.05	95.21	.....	79.75	106.29	99.79	.....	127.17	.....	.....	.....
1888.....	.....	98.71	.....	81.26	107.93	102.45	.....	126.72	.....	.....	.....
1889.....	.....	97.67	.....	84.56	108.16	103.70	.....	127.83	.....	.....	.....
1890.....	.....	96.15	.....	90.34	106.75	100.45	87.05	122.74	.....	.....	.....
1891.....	.....	95.39	.....	93.90	106.00	98.39	85.11	118.59	.....	.....	.....
1892.....	.....	96.34	.....	97.01	106.90	99.97	86.27	115.64	.....	.....	.....
1893.....	.....	98.03	.....	96.84	107.24	100.38	86.27	111.93	.....	.....	.....
1894.....	.....	100.73	.....	99.67	106.59	102.39	90.72	114.01	.....	.....	.....
1895.....	.....	105.86	.....	101.65	105.68	104.44	98.91	112.01	121.53	.....	.....
1896.....	.....	110.55	.....	101.78	105.48	104.58	99.22	108.80	116.23	.....	.....
1897.....	.....	112.06	.....	102.95	103.64	103.59	97.66	112.60	124.53	.....	.....
1898.....	.....	110.62	.....	102.47	.....	102.65	95.52	111.55	125.27	.....	105.31
1899.....	.....	106.84	.....	100.86	.....	99.77	90.71	112.96	129.68	.....	108.20
1900.....	.....	99.29	.....	100.22	.....	95.80	86.74	115.15	134.52	104.04	109.72
1901.....	.....	93.95	.....	100.84	.....	99.54	89.27	112.93	138.32	107.30	109.34
1902.....	.....	94.01	.....	100.22	.....	102.06	92.18	110.47	136.69	108.78	107.93
1903.....	.....	.....	90.44	97.75	.....	102.30	91.49	110.30	135.27	107.09	107.78
1904.....	.....	.....	87.97	97.16	.....	101.94	90.02	106.74	131.98	104.99	105.67
1905.....	.....	.....	89.52	98.83	.....	101.33	90.08	104.61	132.36	104.16	104.00
1906.....	.....	.....	88.01	97.27	.....	99.54	87.73	102.84	130.26	103.95	103.16
1907.....	.....	.....	83.83	94.47	.....	94.66	84.15	100.95	126.58	105.18	102.47
1908.....	.....	.....	*85.92	95.80	.....	‡92.21	82.88	.....	121.25	103.93	100.94
1909.....	.....	.....	*83.76	*97.20	.....	‡95.11	*84.71	.....	119.11	101.47	101.75

*Compiled from weekly statements in London Economist.
‡Compiled from Finanzherald.
Special Docket No. 570, 61st Congress, Second Session, p. 279.

from that of public credit, can such an idea be entertained. Even if it could be carried through Congress, it would put into hopeless jeopardy the relations of the government with the investing public for the future.

§2. If it be accepted as axiomatic that the government must, in the event of a change in circulation methods, in some way take a course that will maintain the value of the bonds so that the banks shall not be obliged to carry them at a heavy depreciation or be obliged to lose the amount of their shrinkage below par, the question remains how it would be possible to protect the banks against loss at the same time that the note issue basis was changed.

Refunding the Bonds

The simplest and most obvious method of effecting the transition would be to refund the bonds directly at a higher rate of interest. The government would say to the banks: You may bring your bonds to us and receive in exchange other bonds of similar par value bearing a higher rate of interest. Or it could say: We will redeem your bonds at par at any time that they are turned in, and you will get the money by a new flotation of bonds, although we know that in order to get par for the new bonds we shall have to pay a higher rate of interest.

What would this operation cost? Light on that question is thrown by the recent sales of government bonds under the terms of the act passed by Congress in February, 1911, which authorized the sale of Panama Canal securities without the circulation privilege, bearing 3 per cent interest. At this rate, the securities brought in rather more than 2 per cent premium. This, however, was on the relatively small sale of $50,000,000. If all of the $730,000,000 of twos now outstanding were to be refunded by the issue of 3 per cents, it is safe to say that not more than par could be realized for them. This would imply an increase of 1 per cent annually on the whole $730,000,000 of debt, a charge which would amount to about $7,300,000 in addition to present charges.

Measure of the Government's Present Borrowing Power

The amount which would thus have to be paid by the government for the purpose of relieving the existing bonds of the circulation privilege would be large, but it should be borne in mind that this is nothing more than a just indebtedness which must be liquidated in order that the creditors of the government may be equitably dealt with.

§3. While the refunding of the bonds at a higher rate of interest is the simple, natural and direct plan for meeting the needs of the case, the question has frequently been raised whether there is not some substitute wherby the cost thus to be incurred would be avoided. The question is specifically asked whether existing bonds could not be allowed to retain the circulation privilege, the banks themselves being permitted, as at present, to buy bonds and secure notes from the government by depositing such bonds with the Treasury.

Other Plans for Using the Bonds

Various plans have come before Congress in which it is provided that, before issuing any notes not secured by bonds, national banks shall be required to have outstanding a specified amount of their capitalization in the form of notes secured by national bonds. This, it is assumed, would leave the banks the privilege of issuing currency, and would keep the bonds on their present basis without the necessity of stripping them of the circulation privilege and thereby incurring a large expense of the kind already indicated. Such plans of course are dependent for success upon the assumption that such a scheme would meet the requirements of bank-note reform sufficiently well. How far would they probably attain that object?

Too much emphasis can hardly be laid upon the statement that such a hybrid proposal as this would not reach the desired end. As we have seen in former chapters, the currency of the United States is now redundant. The national bank notes have displaced gold and gold representatives to an amount equal to their own volume. Consequently, they have taken for themselves a place which ought to be filled, so far as it is filled at all, by gold representatives. The notes do not expand and contract in proportion to changes in credit needs, and consequently there is on their part neither the power to supply a solid legal tender currency nor to furnish the credit element needed at times when demands for loans in the form of notes become urgent. Therefore, a plan which practically retained the existing bond-secured notes would not meet the requirements of the case at all.

National Currency Has Displaced Gold

If the present notes were kept outstanding in practically their total volume, it is questionable how effective a new note-currency which was superadded to them would be. Perhaps it would be only an "emergency currency," subject to all the defects and criticisms which apply in the case of such currency and not fulfilling the ordinary requirements of the situation at all. More probably, the

new currency would at least partially displace the bond-secured notes. If it should do that, the loss on the bonds, although not likely to be as great as would ensue from a complete deprivation of their power to act as security, would be more or less severe, and the banks would therefore suffer correspondingly from the sacrifice involved in the change. However this might be, the combination of a new plan of note issue with the remnants of the old plan would condemn the currency system of the United States to the retention of a foreign and purely artificial body of notes—the bond-secured currency—with all of its well-known evils, for a period of years. This period would continue at least until the maturity of the bonds, or nearly 20 years. Then the country would have an opportunity of deciding whether or not to continue to maintain the circulation power now possessed by the bonds, and might or might not answer in the affirmative. If it did so answer, the result would by the retention of this foreign element of bond-secured currency for an indefinite time.

Discussion of Various Plans for New Currency

§4. Alternative with the two methods of dealing with the bond question, in the event of a change in methods of issuing currency, is the proposal that in some way the cost of making the transition shall be laid upon those who are to get the benefit of the greater convenience, and perhaps larger opportunities for profit, which arise from the introduction of a new method of note issue.

An Alternative Method

In connection with the National Reserve Association plan, it has been proposed that the new institution should be vested with the exclusive privilege of note issue, and in return should take over from the banks at par the total volume of the bonds they now possess. A scheme suggested by some in the same connection has been that the national banks be allowed to continue their present method of issuing notes, and that the new institution be permitted to issue its own notes in addition. This latter variant of the proposal would be open to the objection already sketched, in that it would retain the bond-secured currency in existence. Yet there are legal and other difficulties connected with any plan which would directly deprive the banks, which now own the bonds, of their circulation rights. Discussion has therefore settled down upon the suggestion that, while the existing banks shall be recognized in the enjoyment of their present privileges and be permitted to retain them if they wish, it shall be made to their interest to cede these privileges to

Banks to Choose Between Retaining Circulation Rights and Their Surrender

the proposed new institution and in exchange to receive the assurance of direct redemption of their bonds. The effect of this plan will be to enable a bank to choose between retaining its bonds and its circulation rights and transferring them to the new institution. It is probable that the present national system contains not a few banks which for reasons of sentiment, or on some other ground, would probably retain their circulation privileges if they could be assured of having always the power to transfer their bonds to the Reserve Association at par, so that they would lose nothing.

This plan is considered undesirable for the reason that it would tend to maintain a proportion at least of existing national bank notes in circulation by the side of the new system, and therefore it has been suggested that any forthcoming plan should limit the time during which the transfer to the Reserve Association could be made to a brief period, perhaps a year. If that were done, it is probable that most of the bonds would be transferred to the Reserve Association and would be paid for by it at par, while it would, of course, receive the right to issue an equal amount of circulation, although this circulation would not be directly based on the bonds, as it is at present.

The Monetary Commission's Plan

The detailed scheme by which the Monetary Commission bill proposes to work out this change may be outlined as follows, from the actual measure which has been introduced in Congress to embody the suggestions of the Commission:

> SEC. 48. There shall be no further issue of circulating notes by any national bank beyond the amount now outstanding. National banks may maintain their present note issue, but whenever a bank retires the whole or any part of its existing issue, its right to reissue the notes so retired shall thereupon cease.
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> SEC. 49. The National Reserve Association shall, for a period of one year from the date of its organization, offer to purchase at a price not less than par and accrued interest the two per centum bonds held by subscribing national banks and deposited to secure their circulating notes. The National Reserve Association shall take over the bonds so purchased and assume responsibility for the redemption upon presentation of outstanding notes secured thereby. The National Reserve Association shall issue, on the terms herein provided, its own notes as the outstanding notes secured by such bonds so held shall be presented for redemption, and may issue further notes from time to time to meet business requirements, it being the policy of the United States to retire as rapidly as possible, consistent with the public interests, bond-secured circulation and to substitute therefor notes of the National Reserve Associa-

tion of a character and secured and redeemed in the manner provided for in this Act.

SEC. 55. Upon application of the National Reserve Association the Secretary of the Treasury shall exchange the two per centum bonds of the United States bearing the circulation privilege purchased from subscribing banks for three per centum bonds of the United States without the circulation privilege, payable after fifty years from the date of issue. The National Reserve Association shall hold the three per centum bonds so issued during the period of its corporate existence: *Provided*, That after five years from the date of its organization the Secretary of the Treasury may, at his option, permit the National Reserve Association to sell not more than fifty million dollars of such bonds annually: *And provided further*, That the United States reserves the right at any time to pay any of such bonds before maturity, or to purchase any of them at par for the trustees of the postal savings, or otherwise.

SEC. 56. The National Reserve Association shall pay to the government a special franchise tax of one and one-half per centum annually during the period of its charter upon an amount equal to the par value of such United States bonds transferred to it by the subscribing banks.

§6. It is evident that the effect of this plan would be to enable the banks at once to turn their bonds into current funds, while they would simultaneously lose the power of issuing any notes. An equal amount of notes would, however, be issued (if they were wanted) by the National Reserve Association, so that the "shortage of currency" so often dreaded would not make its appearance. From that time on, those who wished to get notes would have to look exclusively to the National Reserve Association. Few, if any, banks would be willing to take the chance of holding their bonds and keeping their notes outstanding.

The Effect of This Plan

By the terms of the plan outlined, the government would turn these 2 per cent bonds into 3 per cents, thereby involving itself in an additional charge of 1 per cent interest on the total volume taken over. Simultaneously, it would lose the tax of ½ of 1 per cent on national bank notes which is now collected. It would thus, theoretically, be a loser to the extent of 1½ per cent on the total volume of bonds taken over. The Monetary Commission's plan would refund this amount to the government by paying out of the profits of the Reserve Association a franchise tax annually to the extent of 1½ per cent on the total volume of bonds thus transferred. The effect would be to leave the government exactly where it is at present, so far as expense is concerned, ex-

Government Would Be a Theoretical Loser

cept that it would save the various items of outlay which are now involved in caring for national bank currency and which are paid for out of the ½ per cent tax now collected on notes.

The criticism has been made on the plan that it is merely a way of concealing the real fact that the government has to pay the cost of the operation. This is because the Monetary Commission's plan, and every other plan of the same sort thus far proposed, has provided for giving the government all of the profits of a National Reserve Association or other coöperative institution over and above a fair minimum interest on the capital invested. If 1½ per cent on the total volume of the bonds is first deducted as a franchise tax, the volume of profits available for division is theoretically reduced to that extent. Of course this is not quite fair, because in all of the plans that have been suggested, the payment of a fair-going rate of interest on the capitalization of the concern is to be provided for first, and the balance is to be transferred to the government. Under the proposed plan, the franchise tax would be a kind of first mortgage upon the gross income of the institution. It would be one of those expenses that must be provided for in any case, no matter what happened. It would come out of the receipts of the Association before any division of profits was made, whether to stockholders or to the government.

Disposition of the Bonds

One of the good features of this plan would be that the future of the bonds would be provided for. The government does not desire to see its bonds sold at a discount. Yet 2 per cent bonds cannot be sold on any other basis. At 3 per cent they could be sold to investors at par, judging from the prices at present ruling in the bond market. It would be possible, therefore, for the National Reserve Association gradually to sell them out to investors. This would be desirable also from the standpoint of the National Reserve Association itself. It is not well that a large volume of long-time securities should be retained in the portfolio of a great institution which is to deal primarily in commercial paper. As soon, therefore, as the National Reserve Association could relieve itself of the bonds without injuring their standing in the market, it would be well to do so. The Monetary Commission's plan provides for the sale of these bonds at the discretion of the National Reserve Association at a specified rate of $50,000,000 per annum. This would not be a sufficiently rapid rate either to interfere with the floating of new government loans or to clog the bond market. The object would be to have the securities absorbed by

the sound, gilt-edged investment demand of the country, thereby providing a permanent place for the bonds and putting them where they need cause no worry either to the government or to the Reserve Association. They would be taken by persons who want a perfectly safe investment and are willing to accept a very moderate rate of interest. In that way, an equal amount of the fluid capital of the country would be drawn into the Reserve Association in exchange for the bonds, and would be by it used as a basis for banking.

Plan to Avoid Clogging the Bond Market

In the long run, the bonds would thus be entirely eliminated from the commercial banking system of the country and a corresponding amount of bank funds now tied up in these bonds would be released for use in meeting the current demands of the commercial public. That would be a consummation devoutly to be wished.

§7. It would remain true that the power of bank note issue under this plan would be vested in a single great institution and might be referred to as a "note monopoly." This is often mentioned as an objection to the proposal. Just what basis has this objection?

The Question of Monopoly

It should be admitted at the outset that the proposed plan would, exactly as alleged, make the note issue power a monopoly in the sense that it would vest it solely in a single institution. This institution, however, would be controlled by the banks of the country that held stock in it, and any bank that chose to become a stockholder could do so. The "monopoly" existing, therefore, would be a monopoly in the same sense that the power of note issue is a monopoly in the hands of banks generally. Indeed, from some points of view the degree of monopoly of the power of note issue would be less than that which exists at present.

Under current conditions, only national banks can take out notes, and state banks are practically cut off from issuing their own notes, although theoretically permitted to do so, by reason of the 10 per cent tax on issues which is levied in consequence of the act of Congress passed in 1866. Under the proposed plan, state banks would be stockholders in the Reserve Association and could secure the use of its notes on exactly the same terms as national banks. A much more immediate and direct access to bank note issues, and such benefit as may be derivable from them, would

be guaranteed to them. In this way, then, the monopoly element in the control of note issues would be less than it is at the present moment.

In no country are bank notes permitted to issue without any restriction whatever, and in many they are issued only by a single institution, or in the main by such an institution, with a very limited power of note issue surviving in the hands of a few other smaller banks. The chief institution is the residual legatee of this power as it is given up by the other banks. The proposed situation in the United States would provide far less monopoly control than exists in France, England or Germany.

§8. The real question in connection with the problem of monopoly of note issue is not, however, one of theoretical monopoly, but is whether the profits obtained from the use of the notes are properly employed. Where would they go under the proposed system? Presumably they would go to the government in the form of dividends or bonus, after the limited rate of return on capital invested, provided for in the bill, had actually been liquidated. That is to say, the government would get all of the pecuniary benefit accruing to the National Reserve Association through its exercise of the note monopoly. In that case, it would appear that no complaint could reasonably be made, because of the fact that the sole power of note issue had been vested in the National Reserve Association.

Profits From Note Issues

While in some ways this would be a satisfactory assurance, it would not be a complete reply to the charge of monopoly. It might very well happen that all of the proceeds obtained by the use of the note-issue power would actually be turned over to the public by provisions requiring the payment of all excess profits to the government, and yet harm might be inflicted upon the community as a whole through the exacting of excessive charges for the use of the notes. This would be a very serious evil if it existed, and one whose effects could not be waved aside by the mere statement that the profits were all returned to the public. In this connection it should first be noted, however, that if the profits obtained from the use of the notes, like those obtained from other branches of the institution's business, were to go to the government, there would be no inducement from the standpoint of profit for the charging

Possible Harm Through Excessive Charges for Notes

of an exorbitant rate on those loans to customers which took the form of notes.

This reduces the question to the real problem involved, which is: Would the charge made by the Reserve Association for the use of its notes be reasonable, and would it be such as to place the facilities of the institution under the new note plan fully at the disposal of those who needed them? In answering this question, there are several points to be observed. First of all, the plan of the Reserve Association, as already fully shown, would be such as to draw no line of distinction between loans made through the crediting of funds on the books, and loans made through the issue of notes. The reserve requirements would be the same with respect to notes as with respect to deposits, and in every other particular there would be the same general basis of equality. It is evident, therefore, that there would be no reason on the face of things to suppose that the institution would charge an unfair rate for loans which it was desired to take in the note form.

The Real Problem Is the Charge for Notes

Next should be considered the question, What will regulate its rate of discount, whether for loans made in the form of notes or those in the form of deposits? Certainly not the profit to be earned by the institution, for reasons already fully set forth. The institution would be guided in fixing its rate of discount partly, of course, by the general rates current in the community as a whole, and partly by the policy of its directors with reference to the extension or restriction of commercial credit and the controlling of exportation and importation of specie. Whatever their policy on these points might be, there would probably be no time when the rate which they would charge for the issue of bank notes would even remotely approach the high rates which are now charged in those parts of the country where bank notes are chiefly used. In few, if any, countries is there so great a discrepancy between different regions as regards rates of discount, as exists in the United States.

Guides In Fixing Rate of Discount

The main function of the Reserve Association would be to equalize rates of discount charged for paper of similar classes in different parts of the country. It is, therefore, an absolute certainty that, in equalizing this rate, a very great reduction would be effected, as compared with the rates now charged in the more distant and more thinly settled portions of the United States, which are those where the present demand for note currency is greatest. Altogether it is impossible to escape the positive conclusion that the

Cost of Loans In Form of Notes

effect of the proposed plan would be greatly to reduce the cost of loans taken in the form of bank notes as compared with the present rates of charge.

§9. It may be feared by some that, while the rates of charge would be low, the proposed institution would in some way render access to the notes more difficult than at present. That is to say, it might be true that favored institutions under the new regime would be able to get the notes they wanted, and to lend them to their customers, a good deal more cheaply than they now can, yet there might be circumstances and conditions which would interpose to prevent their getting them at all. This is merely another form of the statement that the Reserve Association would tend to be influenced by motives of favoritism.

Access to Notes

No basis for such a charge exists. On the contrary, the proposed plan makes extremely stringent provision for guaranteeing to every bank absolute equality of opportunity and of treatment at the offices of the Reserve Association. Nothing more need be said on that point.

It is worth while, however, to observe that, assuming such equality of treatment, the access of the banks generally to the notes would be vastly easier than it now is. At the present time, those institutions which have large issues of notes outstanding for the convenience of their customers, find, in times of stress, that it is very hard for them to get any further currency. This is due, in the first place, to the fact that bonds are at times exceedingly difficult to obtain under any conditions. A notable instance of this kind was observed during the panic of 1907, when the bonds were practically out of reach so far as related to new note issues. Moreover, banks which are in the habit of issuing notes to meet the needs of their customers are likely to be close to the upper limit of what they can issue, even with an unlimited amount of bonds at their disposal. When they have outstanding a sum of notes equal to their capitalization, they can issue no more.

Easier for Banks to Get Notes Under New Plan

Under those conditions, banks are obliged to obtain the notes by getting other banks to issue and lend such notes, for use by the institutions which stand in need of them. This is a familiar situation at crop-moving times. The notes may be obtained from the larger banks in any one of a variety of ways, either by loans made to officers or directors, or by any of the other roundabout

Roundabout Ways of Securing Notes Now

methods that are familiar. The fact remains that this is the way in which notes are now obtained by those banks that find themselves pretty well up to the limit of note issue. They are, in a word, obliged to depend upon the willingness of other banks to accommodate them. The other banks are sometimes ready to extend this aid and sometimes not.

This merely amounts to a statement that on no conceivable basis could the situation under the proposed plan be worse than that which exists under present methods of banking. Such is, in fact, the case. The methods of the Reserve Association in regard to the issue of notes would, even under the worst conditions, be better than those which have prevailed under the National Bank System at its best. A review of the provisions of the National Reserve plan will confirm this belief in every particular, since it will show that at every point the interests of the several banks have been thoroughly safeguarded as against the Reserve Association, while the motives of self-interest which might conceivably prompt the managers of the Reserve Association to take action in the interest of certain banks or groups of banks, have been carefully eliminated.

Situation Would Be Improved Under New Plan

With every reason to accommodate the public in the matter of note issue, and with the possibility of selfish motives destroyed, the Reserve Association would be found at the service of every part of the country that needed accommodation in the note form, the only question being the presentation of sound commercial paper of the kind specified, in sufficient quantity to get the notes that were asked for. Here, as in every other branch of the business, the question which banks would have to face would be merely the kinds of transactions on the part of their customers which they were engaged in financing. This, however, would be a general question applicable to the whole problem of reorganizing the banking system and not exceptionally prominent in connection with the note issues.

N. R. A. Would Serve the Whole Country

There remains the question whether the interest of the public would be sufficiently safeguarded under the plan which has been proposed for retiring the national bank notes and for putting in their place issues of the National Reserve Association. This is a problem of security.

Security of the Notes

At the present time, the notes of the national banks are protected by government bonds to an equal amount deposited with the Treasury. They may be redeemed out of a fund equal to 5

per cent of their face, which is kept with the Treasury, or out of any funds the banks which issued them may have on hand.

The notes would be backed by gold and other lawful money to the extent of 50 per cent of their value, while they would be payable to the government and could be deposited with the banks, thereby at any time substituting the obligation of a local bank for that of the Reserve Association. This makes it plain that the new notes would be thrice protected; first, by an enormously large reserve kept in the fundamental money of the country, gold; second, by the obligation of the government to receive these notes in payment to it at any time and in any amount; third, by the obligation of every bank in the system to substitute its own promise to pay for the notes of the Reserve Association. The notes would be as sound as the government, and as sound as the whole banking system of the country, which is the same as saying that they would be as sound as the whole structure of the business of the country. More than this could not be required.

Soundness of Such a Currency

CHAPTER XI

THE CLEARING-HOUSE SYSTEM

1. Clearing-House Associations the Only Form of Coöperation—2. Development of Clearing-House Functions—3. Methods of Clearing-House Examiners—4. Government Recognition of Clearing-House Examinations—5. Issue of Clearing-House Certificates—6. Nature of the Issue Function—7. Action by Congress Following 1907 Panic—8. National Currency Associations and Why Few Have Been Organized—9. Associations, both Clearing-House and "National Currency," Have Been Incomplete—10. The Question of Inflation—11. Avoidance of Inflation—12. Advantage of Regularity—13. Need of Extending Clearing-House Functions.

§1. Only one real effort at genuine coöperation has been made by the banks of the national system. This has been seen in the establishment of clearing-houses which, thus far, have been simply informal, unincorporated associations, organized for the purpose of mutual aid, but having in ordinary times only mechanical functions connected with the clearing-process itself. In the following pages it is intended to describe briefly the clearing-house function and to set it in its relation to the general banking problem. It is not designed to discuss the details of the clearing process. These have been made frequently and thoroughly familiar. The intention is to show the position assumed by the clearing-house as an organization in its relation to the banks of the country.

Clearing-House Associations Only Form of Coöperation

The original cause of clearing-house organization was undoubtedly the plain need of coöperation among the banks. Institutions located here and there within the same city or region saw the necessity of mutual coöperation and assistance in exchanging their checks and drafts. This was simply a labor-saving device intended to avoid the necessity of going from bank to bank for the purpose of presenting items for cashing. The constitution of the New York Clearing-house adopted in 1853 provided that the manager, under control of the clearing-house committee, should have full charge of all business and should superintend the operation of clearing, the adjustment and settlement of balances, the

The Need of Coöperation

keeping of the records of transactions as they take place from day to day, and the preparation and publication of detail bank statements. The clearing-house committee was to have charge of the general business affairs of the institution and if necessary to examine any member of the association. A "conference committee" was to be annually elected and its function was, in concurrence with the clearing-house committee, to suspend any bank from the privileges of the clearing-house in case of necessity, until the pleasure of the association was ascertained thereon. No suspension, however, was to take place except under very carefully restricted conditions. Other provisions were intended to govern the membership and the methods of doing business.

The First Clearing-House Association

Throughout the whole list of provisions ran the idea of establishing such rules and regulations as might be considered necessary to control the management of a large business concern chiefly organized with a view to the offsetting of claims and the adjustment of balances. There was no idea at the outset of carrying the notion of coöperation to the extent of protecting the banks which might be members of the clearing-house against one another's operations, should the latter become objectionable. Neither was there any apparent intention of providing for the relief of members of the clearing-house in the event that they should become hard-pressed by creditors or financially embarrassed.

Other clearing-houses were organized on similar lines and those which have been subsequently created have imitated the earlier institutions. The confessed purpose of the clearing-houses is therefore the useful one of effecting a division of labor.

§2. Gradually other functions have been added by the clearing-houses to their original duties. The most natural function to be joined to those originally fixed was that of mutual supervision and inspection on the part of the banks. This early came into existence in a more or less distinct form. Mr. James G. Cannon in his work on "Clearing-Houses" says on that subject:

Development of Clearing-House Functions

> It is significant of the ever widening scope of clearing-house supervision and usefulness that several associations have in the past few years, after giving careful consideration to the subject, appointed special bank examiners, assisted, where necessary, by trained experts under rigid regulation and ready to go to work at a moment's notice. This departure has been deemed of sufficient importance to warrant a complete explanation of the conditions under which these examiners operate.

The mere establishment of associations and the requirement that statements be formulated as thus indicated was only the first step forward. As time has gone on, the general supervision of the clearing-house over its members has been extended to a broad, if vague, requirement that they shall conduct their business in accordance with professional principles and shall scrupulously observe the known and recognized obligations of banking. Thus has come into existence a decidedly important function whose futility has been recognized on many occasions.

Clearing-House Ethics

In all those places where clearing-houses have been organized, an important factor in their work is the establishment of a kind of joint oversight, which enables banks to repress any irregular practices and to maintain a high standard of management among the group of participating institutions taken as a whole. This is rendered possible through regular bank statements prepared by the different institutions, and through the work of a clearing-house examiner, who regularly goes through the different institutions and makes a thorough inspection of their accounts and assets in behalf of the association. Until recently such examiners have worked in only a few cities. During the summer of 1911, however, Comptroller of the Currency Murray induced several cities to appoint regular clearing-house examiners, and, in order to make such action worth while, he indicated a willingness to relieve banks which supported a clearing-house examiner who made regular inspections of a certain number of the examinations usually made by government examiners. The offer was accepted with satisfaction in several places, and the system has thus far worked so well that it is likely to be considerably extended. Thus an informal relationship between the government and a co-operating group of banks has been brought about in so far as inspection and examination of paper is concerned. Even where there is no regular examiner, the banks of a clearing-house, more or less, keep watch on one another's transactions, thus taking, in a loose way, joint action intended to insure soundness in the commercial paper of the community.

Clearing-House Examiners

§3. This most recent extension of clearing-house duties and recognition of the establishments by the government through the order that where clearing-house examiners are appointed the number of government examinations through regular national bank examiners will be substantially decreased, is worthy of further study.

In these cities the clearing-house examiner is appointed by the banks and is jointly paid by them. The aid of a staff of assistants is given him, and together these clearing-house examiners inspect the banks, keeping the results of their inquiries strictly to themselves, so far as details are concerned. If they detect irregularities, it is their duty to call them to the attention of the bank or, in case of necessity, to the clearing-house managers. In a report on the method of conducting clearing-house examinations in Chicago and St. Louis, a report subsequently used as a basis for the introduction of the clearing-house examiner system at Pittsburgh, the following description of the methods employed is given:

Methods of Clearing-House Examiners

> The duties of the Clearing-House Bank Examiner, of what his force consists and the manner in which he performs his duties, as adopted by the St. Louis Clearing-House Association, are as follows: The Department includes the Examiner and three assistants. Before entering upon his duties, the Examiner signs a written contract that in case of his resignation or dismissal, he will not connect himself with any bank or trust company within three hundred miles of St. Louis, for a period of three years, and each of his assistants enters into a similar obligation for the same period. The object of this stipulation is apparent. They have in St. Louis seventeen members of the Clearing-House, and thirty-eight associate members, the associate members being Banks and Trust companies clearing through members. This gives a total of fifty-five banks and trust companies under the control of the Clearing-House, and subject to its rules and examinations.
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> Without notice, the examiner, of his own volition, and with his assistants, enters any bank or trust company and commences his examination. All information he asks for must be given him, and all books and papers placed before him as in the case of a national or state bank examination. When the examination is completed, he makes duplicate reports, stating all the essential facts obtained in his investigation—whether the institution has the required amount of cash on hand, the amounts of its past due paper, the amount of its bad debts, if any, the amount due by the directors as payers, endorsers or as guarantors, and the amount due by corporations in which they are interested, the value of bonds carried and whether they are carried at a sum in excess of the market value, whether the amount shown as capital, surplus and undivided profits is represented not by bad, but by good assets; in other words, whether the published statements are true, and finally, a complete statement of the bank's condition is set out, with any suggestion which, in his judgment, sound banking requires him to make.
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> One copy of the report is delivered by the examiner to the president of the institution examined, and each director of that institution is notified by mail of such delivery, accompanied by a

Chicago and St. Louis System

written request that the director notify the examiner in writing of the receipt of the notice. If, at the end of two weeks, the examiner has not received from the director the acknowledgment desired, he sends a second notice, or a third, if necessary, it being the purpose of the committee to establish the fact that every director of every institution which is a member of, or connected with, the St. Louis Clearing-House, is informed of the condition of his institution as ascertained by the Clearing-House bank examiner.

Bank Directors Notified of Examination

If the examination discloses nothing indicating bad management or unsafe condition, the examiner places the duplicate in his files and writes to the Chairman of the Committee of Management. If, on the other hand, the examiner finds conditions different from the case above stated, he sends a letter addressed to the Chairman of the Committee of Management. A meeting of the Committee of Management, which Committee consists of five members and the President of the Association, who is a member *ex-officio*, is called, and the examiner makes his report, the manager of the Clearing-House acting as secretary of the Committee and keeping full minutes of its proceedings. The Examiner's report is read and considered in detail. He is then directed to notify the President of the institution that the Committee requests that certain steps be taken which, in its opinion, are advisable and necessary.

If this request is not complied with, the Chairman of the Committee requests the President and the cashier of the bank in question to appear before the Committee, when they are notified of the matters complained of and informed that unless they are corrected, their institution will be suspended from the Clearing-House until a meeting of the Clearing-House has been called, and the whole matter in all its details placed before it. The President and cashier are informed at once that no member of the Clearing-House, or any other than those in the room, knows, or will ever know, of the Committee's action or the fact that their institution has been under criticism, provided the required action be taken.

First Action of Report Discloses Bad Practices

In no case yet has the Committee been compelled to suspend a bank or trust company, and in no case has any institution made any complaint that it had become known that its affairs were under discussion. In either city if the examiner finds unwarranted conditions in a bank after having completed his examination, he calls the matter to the attention of the officers of the bank, and if proper adjustment is made, makes no mention of it in his report.

In speaking of the clearing-house examination system, Mr. James G. Cannon says:

> The clearing-house association of Chicago was the pioneer in the establishment of an independent system of clearing-house bank examinations in this country, its system having been inaugurated on June 1, 1906, with results that have to the present time more than fulfilled the expectations of the bankers of that community.

Success in Chicago

The chairman of the clearing-house committee, speaking in this connection only recently, said: "The result of our experience in Chicago is most satisfactory and gratifying. The banks have almost unanimously adopted every suggestion made by the clearing-house committee for their betterment and strength. In several instances, the committee, from its wider knowledge of the financial situation, has been able to save some of the smaller institutions from loss by enabling them to take hold of conditions in time. I cannot properly go into such details as would illustrate the effectiveness of clearing-house examinations as we have experienced it, and can only say in a general way that it has been even more satisfactory than I anticipated it would be before it was undertaken."

Government Recognition of Clearing-House Examinations.

§4. Comptroller Murray's order, in which he directs a substitution of the clearing-house examination for the regular national bank examinations up to a certain point, was first suggested in a letter written by him and reading as follows:

My Dear Mr. ————

The greatest force in this country to-day for safe and conservative banking is a well-organized clearing-house association, having its own clearing-house examiner, and it is my earnest wish that at least every reserve city shall have its own clearing-house examiner.

The three central reserve cities, New York, Chicago and St. Louis, have adopted the plan, and in addition a number of reserve cities, including Kansas City, Minneapolis, St. Paul, St. Joseph, Los Angeles, San Francisco, Milwaukee, Philadelphia, Oklahoma City, Nashville and Cleveland.

Every one of the objections always urged against a clearing-house examiner was used before these clearing-house associations adopted the plan, and every single one of the objections, by actual experience, has fallen to the ground. The fact is that no real argument from any angle can be made against the wisdom and efficiency of such a plan of supervision. Give to the state supervisors of banks all the power they ask; give to the Comptroller of the Currency all the power he may want, and then let each select the very best examiners available, and, even with these ideal conditions, an effective clearing-house association, with an efficient clearing-house examiner, will be by far a more potent factor for sound banking in the community than either or both combined.

The total assets held by all the banks in the United States will approximate $22,500,000,000, making the banking power (capital, surplus, circulation and deposits) of the country $21,000,000,000, a sum greater than the combined banking power of the United Kingdom, France and Germany. Of this vast total, more than one-half is in the central reserve and reserve city banks and represents a power exceeding that of the United Kingdom, and also exceeding the combined banking power of France and Germany.

Nearly one-fourth of the banking power of the country, as a whole, is lodged in the central reserve cities alone, New York, Chicago and St. Louis, and more than another one-fourth is represented by the banking strength of the forty-seven reserve cities.

No stone ought to be left unturned to securely safeguard the handling of this great wealth. If we are to have supervision of banks at all, let us have the best that can be had. And by all means let us have it in our reserve cities. That supervision is not the state examination and control; it is not the national examination and control; but it is the control of an efficient clearing-house association, and an efficient clearing-house examiner, under the authority and with the advice of a clearing-house committee composed without exception of the ablest and most experienced bankers.

There are clearing-house examiners in fourteen of the reserve cities and the plan in each city is in some respects different. I ask you to communicate at once with these different clearing-house associations, and ask them to give you in detail the plan under which they are working.

I also invite your attention to an address delivered by Mr. James B. Forgan, president of the First National Bank of Chicago, on the subject of clearing-house examinations by clearing-house examiners, at a meeting of the clearing-house section of the American Bankers' Association at their convention held in Los Angeles in October last; also, to an article on clearing-house examinations by Mr. Joseph T. Talbert, now vice-president of the National City Bank of New York, which can be found in the Journal of the American Bankers' Association for January, 1909.

So far as argument is concerned, based on actual experience, it seems to me that these addresses of Mr. Forgan and Mr. Talbert contain all that need be said on the subject.

The plan suggested is as follows:

First: In cities where the charge would not be a great burden on the banks they should have their own examiner, selected and paid by the banks of the clearing-house association.

Second: Where this would be such a burden on the banks as to make it impracticable, an arrangement may be made with the national bank examiner to furnish the clearing-house committee with a copy of his report to the Comptroller; and in case there happened to be—as is likely—state banks and trust companies, the bank examiner should make an independent examination of them and report directly to the clearing-house. For this service he would be entitled to a reasonable compensation, but the expense to the banks would be so light as not to make it a burden.

In case the second plan is adopted, of having the national bank examiner or the state bank examiner act as a clearing-house examiner, the details can be easily worked out at a conference between the clearing-house association and the examiner and state

supervisor, if a state examiner is selected, or between the clearing house association and the comptroller, if a national bank examiner is selected.

I earnestly ask that this letter be read at a full meeting of your clearing-house association; that you at once enter into correspondence with the cities having their own clearing-house examiners, that you adopt some one of the plans now working so admirably in those cities, or a modified plan. If you take this up in the spirit which I think you should, and which it is hoped that you will, we will have, in at least all the reserve cities, what we should have had as soon as they were made such—a clearing-house examiner. Yours very respectfully,

(Signed) LAWRENCE O. MURRAY, Comptroller.

The functions of the examination system have been described by another authority as follows:

Other Views of the System of Examinations.

The idea of having a clearing-house bank examiner is not to hamper the banks in any way, but to prevent them from taking undue risks in order to secure high rates of interest, or go into underwriting schemes of a questionable character, or allow directors or officers of an institution loaning the banks' funds to corporations in which they are interested, provided they are not well secured; also to prevent firms and corporations securing larger lines of credit than they should be entitled to, based on their assets, and to enable the banks to check up firms, individuals or corporations that make false statements.

§5. It is thus plain that so far as oversight is concerned the clearing-house association has demonstrated its efficiency so clearly as to be recognized by government authority. But by the side of this function has been developed another which has been exercised only in exceptional instances. This is the so-called clearing-house certificate or currency function which in substance has been the providing of a certain kind of reserve resource through the concerted action of the banks, in order that they may be relieved of the pressure and danger growing out of severe strain upon their resources in times of panic or stringency.

Issue of Clearing House Certificates.

The earliest issue of clearing-house loan certificates occurred in 1860. There had been a serious decline in bank business toward the close of 1860. In consequence the clearing-house banks of New York adopted a resolution whereby it was proposed that any bank in the association might, at its option, deposit with a committee of five persons to be appointed for that purpose an amount of its bills receivable, United States stocks, Treasury notes, or stocks of the State of New York, to be approved by the Committee, which

First Used in 1860.

should be authorized to issue thereon to the bank depositing them certificates of deposit, bearing interest at 7 per cent per annum, in denominations of $5,000 and $10,000 each, to an amount equal to 75 per cent of the deposit. These certificates might be used in the settlement of balances at the clearing-house for a period of 30 days from the date thereof, and were to be received by the creditor banks during that period daily in certain proportions. The association also agreed that the specie belonging to the associated banks should be considered and treated as a common fund for mutual aid and protection, and a committee of the clearing-house was given authority to "equalize" the fund by assessment or otherwise as occasion might seem to demand.

This expedient was again resorted to in 1861, and again in 1863 and 1864, but after that date no further loan certificates were issued until 1873, when a very much larger issue was made. In that year also the loan certificate expedient was adopted by the Boston clearing-house association and by those of Philadelphia, Baltimore, St. Louis, New Orleans and Cincinnati. Again in 1879, a small issue was put out by the New Orleans association, and again in 1884, New York resorted to the certificates. In 1890 there were issues in New York, Boston, and Philadelphia. In 1893, the use of the certificates was again undertaken, and issues were made at New York, Boston, Baltimore, New Orleans and Cincinnati. Small issues were put out at Buffalo, Pittsburgh, Detroit, Atlanta, Birmingham, Richmond, Chattanooga, and other places. Again in 1896, there was a small issue at New Orleans, and a small issue in 1895-1896 was used at Boston and at Philadelphia.

Other Issues of Such Certificates

Probably the most extensive issue of clearing-house certificates ever made was in 1907 when New York and practically all of the other principal cities of the country issued clearing-house loan certificates. In many smaller manufacturing towns there were issued so-called clearing-house checks or cashier's checks in small denominations to supply the need of cash. These were simply checks printed from steel plates in small denominations and issued to the various clearing-house banks, which then signed them, through their cashiers, and paid them out to persons who desired funds. In some places, the clearing-house loan certificates were made the basis for issues, dollar for dollar, of clearing-house checks running as low as one dollar in denomination.

§6. It is obvious from this outline that the essential function performed by the clearing-houses in connection with the issue of loan certificates and checks has been the rediscounting of paper. Such rediscount was in the form of a credit which was practically as good as legal tender money inasmuch as, by common agreement, the banks of the clearing-house associations undertook to receive it in payment of all obligations, and thereby converted it into a means of cash payment available to any reasonable amount. They substantially entered into an agreement not to attempt to drain away one another's cash, but to treat the cash as a common fund.

Nature of Issue Function

The purpose of the clearing-house certificate system has been to afford the banks the means of liquidating paper at a time when they are peculiarly in want of cash owing to panic demands upon them. The banks which feel the need of cash hypothecate, with a committee of the clearing-house, paper of satisfactory quality which they happen to have, and get in return clearing-house loan certificates to (say) 75 per cent of the amount of the paper thus pledged.

Purpose of Certificates Was to Meet Panic Demands for Cash

By making the clearing-house certificates payable in liquidation of all sums due from one bank to another, the clearing-houses have practically relieved their members for the time being of the necessity of directly settling in cash such obligations as are presented to them by other banks. Since a rate of interest is charged on the certificates, the banks desire to retire them as soon as they can.

The use of these certificates practically throws the whole body of clearing-house banks into the form of a commercial unit during the period of stringency. This is probably the highest and closest form of coöperation established among the banks.

Highest Form of Coöperation.

The success of the plan is evident from the repeated employment of this expedient over a period lasting half a century, and by the continuous extension of the system to the smaller clearing-houses which have taken it up in recent years as necessity seemed to demand.

The success of the clearing-house loan certificate plan has often raised the question in the minds of observers why this plan was not made a permanent feature of clearing-house organization so that it could be resorted to at any time, and the very great power of expansion in accommodation resulting from it be realized. So acceptable has this notion been to many persons, that for years past there have been bills regularly presented to Congress for the pur-

Success and Permanence of the Plan

pose of legalizing issues of loan certificates by recognizing the right of the clearing-houses to get them out—a right which is, to say the least, very doubtful under the conditions of existing law. Very little support has been accorded to these efforts by the clearing-house banks themselves. Apparently, their view has been that the legalization of the scheme, and the adoption of an act making it permanent, would destroy its basis of success. It has been contended that, if the scheme were to be regularly resorted to, the effect of it would be to encourage banks to expand their operations because they would know that they could get relief at any time by applying to the clearing-house committee and obtaining loan certificates. What is good medicine for a sharp attack of disease, it has been picturesquely stated, is not desirable as a regular diet. This aphorism hardly meets the real facts in the case, but at all events it explains the grounds upon which there has been a hesitation on the part of bankers to see the clearing-houses regularly endowed with the function of issuing these certificates.

Arguments Against Legalization of the Plan

§7. Without the support of bankers and almost against their wishes, Congress, however, has practically legalized something analogous to the clearing-house certificates. After the panic of 1907, there was a strong demand for legislation which would render the recurrence of such an event improbable or impossible. Under the stimulus of popular demand, Congress, which had previously been indifferent to the wishes of the community in regard to banking reform, attempted to adopt legislation designed to avoid future panics. Two plans were placed before it, the one simply providing that banks might, if they desired, present bonds of specified kinds, other than national, to the Treasury Department and receive back circulating notes in a specified proportion of the face of the bonds. Such notes, however, were to be quite heavily taxed on the ground that they were an "emergency currency" and as such to be "driven in" as soon as possible.

Action by Congress Following Panic of 1907

The other plan provided for the issue of notes by associations of banks to be organized in various districts into which the country was to be divided. Notes of this kind were not to be based upon any specified securities expressly segregated for that purpose, but were to be in the nature of so-called "asset currency" protected by the joint action of the banks in the district associations. Finally,

after several months of struggle, a new plan was evolved whereby so-called "clearing-house associations" were to be formed for the express purpose of getting out notes when desired. Ultimately this again was changed to a plan for the formation of "National Currency Associations" which were to have nothing to do with clearing-houses, but were apparently intended to be the inheritors of that part of the clearing-house function which had been previously represented by loan certificate issues.

This plan was at last consolidated with the bill which provided for the issue of notes direct from the Treasury to banks which might deposit approved securities (other than national bonds) with it, the resulting legislation being known as the "Aldrich-Vreeland" law.

No Notes Have Been Taken Out Under This Law

In this law it was provided that in addition to the issues of notes which might be obtained direct from the Treasury, other issues could be had from the National Currency Associations. Such associations would consist of not less than ten banks having a combined capitalization of at least $5,000,000, situated in contiguous territory. The issue of the notes was to follow lines that had already been made familiar by the clearing-houses. Securities of a specified kind were to be receivable by the National Currency Associations and, when thus received, issues of notes up to 75 per cent of the value of the securities might be obtained from the Treasury by the Association and distributed to the banks which had deposited the collateral with the National Currency Associations. The banks in any association were, however, to be jointly responsible for the notes thus obtained and issued. Under this plan no notes have ever been taken out and only a few such associations—seventeen in all—have been organized.

Why Associations Have Not Been Organized

§8. It is clear that, with the National Currency Associations as with the clearing-house associations, what has been done has been to provide a means for rediscounting commercial paper, the form of the rediscount being the issue of notes jointly guaranteed by the banks which were the members of the organization applying for the notes. It would be easy to say that the failure to organize more of these associations and the entire failure to get out any notes is due to the fact that no commercial crisis or stringency has supervened since the legislation was adopted that would render such a force necessary. Of course, this neglects the fact fully commented upon elsewhere in this discussion, that the clearing-house associa-

tion or National Currency Association merely fills a need which constantly exists, and that in the past issues of notes by such associations have occurred when it was impossible to get along without them on account of the extreme necessities of the case. The reason why no notes have been issued by the National Currency Associations is not altogether that there has been no occasion to demand them. Nor can any similar explanation be accepted for the failure to get out clearing-house certificates except during certain specified years when panic or stringency had driven the banks to a resort to that expedient.

Clearing-House Notes Regarded As An Extra-Legal Expedient

In the case of the clearing-houses, the notes were not issued except upon extraordinary occasion and were then driven in as early as circumstances would permit, because the strong banks did not care to be responsible for them any longer than was necessary, and because the whole thing was looked upon as an extra-legal, if not an illegal, expedient.

In this case of the National Currency Associations, the inactivity may be attributed to the fact that the getting out of such notes is severely penalized by the imposition of a very heavy tax upon them and by the fact that the notes constitute an unlimited liability upon all of the banks which are parties to the National Currency Association. Moreover, through defects in the law, the character of the commercial paper which may be received by such associations as a backing for issues of notes is very far from being clearly described, so that in many places it would appear that very little paper would be available as security behind the notes if the law were rigidly adhered to. But, entirely apart from all these questions of technique is the fact that the issue of notes or loan certificates is manifestly a temporary expedient upon a temporary basis and is vitiated by this "emergency" quality. The banks do not care to arouse alarm by employing an expedient which is regarded by the community as a danger signal, while no individual bank is willing, except in case of extremity, to ask other institutions to consider the getting out of notes, since this step would necessitate an exposure of its own affairs, and an explanation of the reasons which had led it to so unusual a step.

Defects In the Law

§9. It is clear that the associations, whether clearing-house or national currency, have been incomplete in their operations and that what they lacked was (a) legal sanction and recognition as permanent institutions, and (b) legal oversight and restraint.

Associations Have Been Incomplete

The harm that came from issues of certificates was due to the fact that they were regarded as the result of danger, if not of disaster. The good that came from them lay in the fact that they converted sound and unquestionably valid assets into immediate means of payment. The danger seen in them resided in the fact that it was feared that they would give to weak institutions a power to expand accommodation to which they were not entitled and which might work hardship to sounder and better managed institutions.

The coöperative idea implied in the associations was their distinguishing beneficial factor, and it is this that should now be carried a step further by placing the clearing-houses or national currency associations upon a permanent working basis—or what is the same thing, by borrowing the idea of coöperation from them and organizing an institution to apply it regularly and systematically. Such an institution would maintain and accept the germ idea of the clearing-house or National Currency Association—that of the rediscounting of paper and the conversion of it into resources which might be used as reserve funds. It would, however, carry this notion further by keeping the institution always open for business and thereby rendering it possible for its operations to go on without shock or alarm to the community. Involved in this thought would also be the abolition of everything that could be considered to penalize the use of the resources of the institution. Proper restraint and oversight would be obtained by the application of professional knowledge and skill to the business of testing paper presented for rediscounting.

The Coöperative Idea

§10. With such professional skill and oversight applied to the operations of a coöperative association, how far would there be a warrant for the belief of inflation? The belief is frequently expressed that the clearing-house principle, so-called (meaning thereby the principle of converting assets into immediate resources), would be carried to an extreme, and inflation would result. It is well to note the exact effect produced by the clearing-house loan certificates when they were issued, and to consider the probable result of producing this same effect under usual circumstances.

The Question of Inflation

The action of the clearing-houses in issuing loan certificates (and the action proposed for the national currency associations)

was to be that of accepting given securities and issuing notes in exchange therefor. In ordinary discussion, it is assumed that these issues gave relief because they "increased the quantity of money" in the community. A shortage in money had been brought about as a result of public clamor and uncertainty, and this shortage had to be relieved in some way. The relief was obtained, it was supposed, by issuing notes which took the place of some money that had been withdrawn from the banks and had disappeared through hoarding or otherwise. This was a complete misapprehension of the situation and was not only erroneous in its statement of facts, but in its view of the theory upon which the action of the clearing-house was founded.

Popular Misapprehensions of Reasons For Clearing-House Issues

The conditions by which clearing-house banks have found themselves confronted in times of difficulty have been that, although assets of known value were available, they could not be quickly tested and converted into resources, thus making them available for the purpose of liquidating obligations whose settlement was called for.

The issue of the loan certificates grew out of two distinct propositions: (1) the joint guaranty by the banks of the paper offered to them, since they issued notes based thereon to the extent of 75 per cent of the paper accepted; (2) the creation of a readily available and recognizable form of resource. It should be perfectly plain that precisely as much good would have been done, had the clearing-house, instead of issuing these "certificates" or "notes," granted to the banks presenting paper and asking for the certificates a right to draw upon the clearing-house a check which should have been valid simply in payments to other banks. Confusion has arisen from the use of paper certificates, or notes of the kind referred to, which have effectually masked the real nature of the transaction. This real nature lay in the examination and testing of credit paper and in the joint agreement to accept such paper when once it had been tested and certified.

Real Nature of the Transaction

Now, what is inflation? It is currently stated that, if clearing-houses were to continue the operation just described, the result would be inflation. So eager have clearing-house associations been to avoid this danger, that they have usually penalized the use of the certificates by charging a very high rate of interest on them. This has been intended to "drive the certificates in," and, as the certificates have usually come in very rapidly when the need for

What Is Inflation?

them was over, it has been supposed that they had been driven in by this rate of interest or tax. Inflation, however, is not to be feared if every loan is based upon sound values which are promptly redeemable.

The avoidance of inflation is found in redemption. Constant redeemability of obligations means that these obligations cannot become inflated—that is, cannot become too numerous. If, for example, an issue of bank notes is thoroughly and fully protected by cash reserves, yet the notes on the average remain in circulation for some time, the meaning is that the notes are needed in circulation and that the community is more benefited by having them kept outstanding than by having them redeemed and retired. If there is no method of prompt redemption, or if there is an artificial stimulus to the issue of notes which has no relation to commercial necessities—as in a bond-secured currency—then there may be inflation. That is to say, the notes may get into circulation and stay there without reference to the exchange function they perform.

Redemption the Remedy for Inflation

This inflation may occur just as easily in the granting of bank credits. The danger is there seen when banks accept paper and allow deposit credits on the strength of it, notwithstanding that the paper cannot be promptly met or is of doubtful value. In this case, banks are practically putting their resources behind property which does not grow out of actual commercial exchanges and which, therefore, however good it may be in the long run, is not a quick asset. Persons who know that they can go to banks and obtain abnormal credit in this way, whether it be in the form of notes or deposit accounts, recognize that they are able to use as purchasing power values which under other conditions they would have great difficulty in disposing of.

Credit Inflation

This is inflation, and it is a process which has nothing whatever to do with the amount of currency in existence or in circulation. From this, then, it is clear that inflation is to be feared only when the extension of credit is made upon an unwise basis and when, therefore, there is doubt about the immediate convertibility of the credit that is granted and, perhaps, some doubt even about its ultimate convertibility. By convertibility is not necessarily meant convertibility into "money" or "currency," as many persons loosely assume. It means convertibility either into money or into bank credits that have more recently been created.

Prompt Exchange the Test of Soundness

Activity and prompt exchange are the tests of soundness. When there is this kind of activity, there is nothing to be feared from the extension of credit in the way described.

§11. Inflation is avoided, therefore, when paper is carefully tested before being guaranteed, and is found acceptable as a basis for immediate funds. If this testing is carried out with sufficient care, and if it applies only to the live assets of the community, there is nothing to be feared from a constant resort to it. Moreover, there is no occasion for penalizing those who make use of it. The charge properly made by them is the regular commercial charge for the use of capital in a given form for the period the paper has to run. By making this charge, an institution, or a coöperative group of institutions, is relieved of the necessity of "carrying" any paper, and merely extends a business service for which it is properly compensated. Those who thus convert their assets into immediate resources do so because such resources are more valuable to them than the cost of making the exchange. They convert their paper into resources in this way because other persons are calling upon them to liquidate demand obligations or because they see a possibility of using these resources as a means of extending their business still further. For either of these reasons, they are willing to pay the price of conversion. When they have done so, there is no hazard or risk unless they are unable to meet their maturing obligation when it falls due, or, what is the same thing, unless the person or firm who made the paper originally is unable to meet it when it falls due. In either of these cases there has simply been a miscarriage of the conversion operation—that is, something has been mistaken for quick assets which was not so. The remedy in this case is not to make it more expensive for all future borrowers to get their accommodation, but is to employ more capable men or to install a more effective system for the purpose of testing the paper that is offered as a basis for credit.

Avoidance of Inflation

The Price of Conversion

§12. In this matter of converting commercial obligations into means of payment, just as in all other banking operations, there is an immense advantage on the side of regularity. The operations of the clearing-house were unsatisfactory as regards the issue of loan certificates because the function was an irregular one.

Advantage of Regularity.

There was no regular machinery for carrying it on, nor was there any specified capital set apart. The loan certificates consequently came into existence sporadically, and by means of hastily organized processes. The same thing would necessarily be true of the currency now permitted to be taken out by National Currency Associations, although the hasty and unorganized character of the transaction would not be so conspicuous with them as it was with the clearing-houses.

Application of the Clearing House Principle.

Neither institution can afford the steady responsible type of accommodation that is wanted. That can be obtained only by setting aside a definite capital and creating a definite organization to do the work of converting heterogeneous commercial credits, varying in origin and in type and resembling one another only in their activity and short term, into immediate means of payment. Such an institution, operating in the way indicated, has all the advantage which come from economy and regularity in its operation. It represents simply the further carrying out of the cooperative principle embodied in the clearing-house and the subjecting of this principle to stated and recognized methods of application for the benefit of all who may need to invoke its assistance.

Need of Extending Clearing House Functions.

§13. From what has been said, it must be plain that an organization of banks which undertook to carry further the principles involved in the joint testing of credits would find that the other functions allied to this testing of credit which had heretofore been performed by clearing-houses would be much more easily performed by such an organization. It has been seen how clearing-house banks coöperated for the purpose of bringing pressure to bear upon every member in order to compel them all to avoid questionable practices and to live up to the best professional methods in vogue. It was noted that this result is accomplished by ordering either periodic and sporadic, or (where a clearing-house examiner is employed), regular examinations or tests of the condition of the banks. There will always be a field for the exercise of this function of joint examination no matter whether the ultimate process of testing paper and converting it into immediate resources be confided to some special institution or not.

It is plain that the work of such an institution, if properly carried out, would render immensely more simple the problem of exercising the proper mutual control over bank operations. It

would place a heavy premium upon those methods of banking which resulted in the creation of the right kinds of paper and would penalize those methods of banking which resulted in granting accommodation to persons who were not entitled to it as estimated by the immediate character of their resources. While, therefore, an institution of the kind described would be able to do vastly more effective work than the clearing-houses by simply carrying the principles employed by them to a higher point of perfection, it would in no wise usurp their functions. They would still have an abundant field for the performance of the work which they were fundamentally authorized to undertake—that of clearing checks and items that were deposited with the various banks. They would, moreover, exercise an oversight over one another which could not be exerted by any other institution of more general scope.

Would Make Better Banking.

Unless such an institution were organized with branches, which has been proposed by nobody under existing conditions, it would be necessary for the work of testing credit and making loans to be complemented by the efforts of the clearing-houses. But this work of testing credit and making loans must be carried on with a fixed capital and upon a definite basis of business enterprise. Without that, it inevitably assumes the temporary or sporadic character it has heretofore had under the clearing-house system, and which it would necessarily retain under the plan provided for in the Aldrich-Vreeland Act.

A coöperative institution would introduce no new principle beyond that which has been pursued by the clearing-houses and which it was sought to legalize in the Aldrich-Vreeland Act. All that would be done would be to carry this principle further, systematize its working, and subject it to the safeguards and checks which are necessary in order to prevent undesirable conditions from growing up. The only element of novelty in the system would be that of organization and stability of method coupled with the extension of the plan harmoniously throughout the country.

Only Element of Novelty.

CHAPTER XII.

COÖPERATION OR CENTRALIZATION?

1. Three General Types of Banking.—2. Banking Systems in the United States—3. European Banks—4. Canadian System—5. Defects of the Competitive System in the United States—6. Statistics as to Distribution of Reserves and Deposits—7. Tendency to Concentration of Control.—8. Development of Joint Control—Holding Companies—9. Effect of Government Deposits—10. Coöperation under Present System Limited—11. Organized Legal Coöperation—12. Economy of Reserves—13. Kinds of Paper Rediscounted—14. Gains of Legal Coöperation—15. Summary.

Three General Banking Types

§1. A review of the banking systems in vogue throughout the world at the present time shows that they may be classified as belonging to three general groups or types: (1) Those depending on a central bank as their principal feature; (2) those based on independent competitive banks; and (3) those involving a coöperative principle. The question as to which plan is best adapted to the needs of a commercial country has been actively discussed for a long time. Probably no final answer can be given to it. The decision in every case must depend upon the conditions existing at the time in any given country. In general, the tendency of modern commercial countries has been away from the purely competitive and independent type of banking system. There has been a strong drift toward either centralization or coöperation. In some cases, this drift has been guided by legislation; in others, it has gone on without any official or legal recognition, simply by virtue of the demands of business and economy of resources.

A Central Bank In United States

§2. Early in the history of the United States, the idea of centralization in banking was advocated. Hamilton urged the establishment of a large central bank in his famous report on that subject in 1791. Later in the same year such a bank was actually established and lasted for twenty years. Meanwhile, many banks

had been chartered by the several states and had come into operation on a competitive basis.

After the close of the charter granted the first bank of the United States, a renewal was refused by Congress, and there ensued a period of about five years during which full opportunity was given state banks for development. In that period, the United States government had no single financial institution upon which to rely, but called upon the state banks for such loans, and other banking facilities, as it stood in need of. This proved unsatisfactory, and in 1816 the Second Bank of the United States received a twenty-year charter. This bank, like its predecessor, acted as fiscal agent of the government, furnished such loans as the Treasury needed, and generally exerted a steadying and controlling influence over the state banks, which continued to be chartered upon a competitive basis. A renewal of its charter was also refused after a long and bitter political struggle, lasting from 1829 until the close of the existence of the institution.

From 1837 down to the Civil War, the system of banking in the United States was entirely under state control and rested on a purely competitive basis. No federal legislation relating to banking was adopted, and the only serious innovation upon previous conditions was found in the establishment of the independent Treasury, which was to act as the custodian of public funds. Under this state banking system, as many different kinds of currency as there were banks in the country were issued, while the government could not in case of necessity obtain the support of any very strong single institution.

State Banks

After the opening of the Civil War, the national bank act was passed (1863) for the purpose of supplying a uniform currency and aiding the government, through the purchase of bonds which were to be used as security behind bank notes. Later (1866), state bank notes were driven out of circulation by a ten per cent tax levied upon them. Access to the banking system was free, those who would organize a bank being permitted to do so without restriction, provided they were able to furnish the necessary capital and comply with moderate requirements concerning the conduct of business.

National Banks

Since 1863, the national banking system has been continually in existence and nearly 10,000 institutions have been chartered at the date of the last Comptroller's Report, 1911, of which 7,301 are

still in existence. States and territories have in the meantime gone on incorporating banks under their own laws. Thus there has been perfectly free competition in banking throughout the United States, save in so far as related to the issue of notes. This function has been reserved to a single class of banks—those in the national system—but within the national system there has been absolute freedom of action in issuing notes subject to the requirements of the national bank act. These restrictions have been the same for all banks of similar size.

§3. The course of development in the United States has been very different from that which has existed abroad. In England, the Bank of England was chartered in 1694 and has continued from that day to this, standing in a peculiar relation to the government as its fiscal agent, and ultimately taking to itself the function of note issue in a practically exclusive manner. By long-developed custom, the Bank of England has become the reserve holder of the country and has grown into what is practically a banker's bank, although it does an extensive business with individuals. In this peculiar position, the Bank of England is able to act largely as the financial dictator of the English credit system—a power which it has exercised with judgment, non-partisanship and discretion.

Bank of England

In France, the Bank of France was developed in 1800-1803 and has continued in operation since that time. It enjoys a monopoly of note-issue, practically holds the reserves of the country, and, while doing an extensive business with individuals, also serves as the great market for rediscounting paper presented by other banks and financial institutions. With its system of branches throughout France, it operates as a controlling agency, regulating in the main the banking customs, and determining the flow of specie into and out of the country, subject to the general conditions of international trade.

Bank of France

Similar functions are exercised by the Imperial Bank of Germany, organized in 1875. Most of the continental countries of Europe have followed this same system of establishing central institutions, standing in close relation to the governments of these states and exercising a general oversight over banking. Most of them, however, are privately owned. A recognition of the public quality of the service with which they are entrusted is obtained by subjecting them to constant and watchful government oversight,

Reichsbank of Germany

while in the case of most, there is direct governmental participation in the management of their affairs. The effort is made in every case to give the commercial public a voice in the management of the institutions, and to ensure that they shall be carried on in such a way as to serve the commercial interests of the countries where they are situated. European Central Banks

The pressure of public opinion in the highly organized and closely centralized countries of Europe also has an important influence in keeping the banks true to their public quality and preventing them from neglecting the duties which fall upon them in consequence thereof. Thus, in most of the European states, the basis of the banking system is found in a strong central bank which constitutes the connecting link between the government and the public. This bank holds the reserves of the other banks to a very large extent, and furnishes credit to the community, besides regulating the importation and exportation of specie.

§4. Canada has developed her banking system in a different way, and may be regarded as the best example of the coöperative type of banking to which reference was made above. The peculiarity of Canada's system lies in the fact that, although there is no single institution possessing an exclusive monopoly of note-issue, or of any other function, and although there is no government bank holding public funds and possessing the power to dictate the use that shall be made of the cash resources of the country, practically all of Canada's banks are of large size. At present only twenty-seven different institutions are in operation, and the requirement of the law is that no new institution shall receive a charter if it has a capital below $500,000. Every bank is permitted to establish as many branches as it sees fit, and some institutions operate hundreds of such branch offices, there being in all nearly 2,000 branch offices. Notes are issued by all of the banks, but they are guaranteed by a fund which is contributed by the various institutions, and which is used for the purpose of redeeming the outstanding notes of failed banks, being reimbursed, so far as possible, from the assets of such banks when their affairs are settled. Canadian Banking System Branches

Thus Canada, without having a centralized banking system, enjoys many of the advantages of such a system. The number of responsible managers of the banks is small and consultations can easily be had. The banks—as said—are all substantial in size, and

the degree of coöperation among them is high, even in those particulars that are not subject to legal regulation. Under the law, they are required to coöperate absolutely in safeguarding their notes, and they have always succeeded in protecting them fully. On the other hand, a measure of competition is assured by the possibility of chartering new banks, each with the issue function, at any time when applicants with sufficient capital in their possession present themselves. Moreover, the keenest of competition in serving the public is secured through the operation of the branch system. Thus, although access to the Canadian banking system is not a mere routine matter, as it practically is in the United States, there is an approach to free banking at the same time that there is preserved a very substantial part of the advantages of central banking.

Our National Banking System Competitive

§5. The United States affords probably the best example of a competitive or free banking system. In the effort to assure perfectly unhampered access to the system, admission has been made general, the law providing for the granting of charters through a merely routine or administrative act on the part of the Comptroller of the Currency in Washington. In order to prevent the pressure of competition from being applied by large institutions to small ones, the law has practically prohibited the establishment of branches, while interpretations of the act by the Supreme Court have rendered it illegal for one bank to control the stock of another.[1] Altogether the idea of individualism and separation in banking has been developed here as far as law could bring it about. The good features of this system have been so fully realized that it is probable that its fundamental features may be regarded as firmly fixed. There is no probability that free access to the business of banking will be denied under any legislation. At present there seems to be little chance that the establishment of branches will be permitted. This means that there will be a permanent retention of conditions in which many very small banks must exist in order to meet the needs of the communities they serve, and in which there will be no direct control by one institution, or group of institutions, over another.

The maintenance of such conditions necessarily involves some rather serious suffering. Among the difficulties which have been

[1]See California National Bank vs. Kennedy, 167 U. S. 362; also First National Bank of Concord vs. Hawkins, 124 U. S. 364.

found to be characteristic of the national system, are those of wide diffusion of reserves, extravagance in the use of banking resources, lack of coöperation, inability to finance large operations with ease, lack of control over the exportation and importation of specie and numerous others. Yet it is probable that all of these defects would be endured if it were true that competition and independence had been maintained contemporaneously with them, or that it could not be had without them. Neither of these suppositions holds good; for today a high degree of banking centralization has, unknown to the community, been produced; while an easy means of escape from it and from the evils incident to the present system is undoubtedly available. The truth about existing conditions in the banking system of the United States and the actual degree of centralization that has been attained can be best understood from a survey of the present relations between banks. How this system operates to put the funds out of the control of their owners is seen by a survey of the actual distribution of reserves at the present moment.

Defects

§6. The following figures show the reserves of country national banks (1883-1910) classified as lawful money held, due from reserve agents (held by other banks on deposit), redemption fund (held by the Treasury).

Date	Number of banks	Classification of Reserve: Lawful money	Due from agents	Redemption fund	Total amount
		Millions	Millions	Millions	Millions
Oct. 2, 1883	2,253	$61.0	$84.1	$11.3	$157.5
Sept. 30, 1884	2,417	66.1	79.7	10.5	156.3
Oct. 1, 1885	2,467	71.4	95.9	10.2	177.5
Oct. 7, 1886	2,590	77.9	99.5	8.7	186.2
Oct. 5, 1887	2,756	83.4	100.9	6.6	190.9
Oct. 4, 1888	2,847	84.7	119.0	6.2	209.8
Sept. 30, 1889	2,992	86.7	132.4	5.5	224.6
Oct. 2, 1890	3,207	92.0	128.5	5.2	225.5
Sept. 25, 1891	3,333	97.1	133.0	5.4	235.5
Sept. 30, 1892	3,430	105.5	163.5	5.8	274.8
Oct. 3, 1893	3,434	117.1	106.9	6.6	230.6
Oct. 2, 1894	3,411	106.8	161.6	6.5	274.9
Sept. 28, 1895	3,365	102.3	147.7	6.6	256.6
Oct. 6, 1896	3,329	119.0	125.0	7.2	251.3
Oct. 5, 1897	3,276	111.7	192.5	7.2	311.4

Distribution of Reserves

Date	Number of banks	Classification of Reserve: Lawful money	Due from agents	Redemption fund	Total amount
		Millions	Millions	Millions	Millions
Sept. 20, 1898	3,259	$116.4	$209.6	$7.1	$333.1
Sept. 7, 1899	3,274	123.6	274.0	7.4	405.0
Sept. 5, 1900	3,540	122.0	282.9	9.4	414.3
Sept. 30, 1901	3,885	130.4	288.1	10.4	429.0
Sept. 15, 1902	4,268	134.7	150.7	10.2	295.6
Sept. 9, 1903	4,691	150.8	155.8	11.8	318.4
Sept. 6, 1904	5,065	150.9	163.8	13.1	327.8
Aug. 25, 1905	5,412	164.2	181.9	14.5	360.6
Sept. 4, 1906	5,781	177.5	204.7	16.2	398.4
Aug. 22, 1907	6,178	199.6	226.7	17.2	443.5
Sept. 23, 1908	6,482	215.8	220.1	19.1	455.1
Sept. 1, 1909	6,595	219.7	241.5	20.6	481.9
Sept. 1, 1910	6,791	229.8	258.3	21.1	509.3
Dec. 5, 1911	6,949	246.3	283.1	22.3	551.7

The showing indicates the extent to which the country banks have placed their resources at the disposal of others. In 1911 much less than one-half ($246.3 millions) the total reserve ($551.7 millions) was in the actual possession of the country banks.

Redeposits In Other National Banks

But the practice of redepositing bank funds has been carried much beyond the limits of the reserve system. In the following table is reviewed the growth of the items "due to national banks," and "due to state and private banks" during the years since 1875. The figures are given by five-year periods down to the year 1900 and once a year thereafter, the date chosen being the earliest report date in each year. From this compilation it can be seen that, while the growth in the items has been irregular, the tendency has been strongly upward. For the report of January 31, 1910, the figures show $962,000,000 against $137,000,000 in 1875. For 1900 (February 13), the figure was $536,000,000. The item "due to state and private banks" does not show the same steady growth, but

In State Banks

fluctuates considerably, though it is now largely in advance of the figures for 1900. One reason why this latter item has not grown more rapidly may be the large development of the trust company system and the increase of deposits in national banks carried in favor of these institutions. Taken in the aggregate, the items "due to banks" have grown much faster than the capitalization of the national system.

Bank Deposits in National Banks

Date	Due to National Banks Millions	Due to State and Private Banks Millions
Mar. 1, 1875	$137	$ 55
Feb. 21, 1880	170	65
Mar. 10, 1885	205	82
Feb. 28, 1890	297	137
Feb. 28, 1894	343	173
Feb. 13, 1900	536	318
Feb. 13, 1900	518	318
Feb. 5, 1901	655	273
Feb. 25, 1902	685	311
Feb. 6, 1903	673	298
Jan. 22, 1904	692	293
Jan. 11, 1905	753	312
Jan. 29, 1906	825	364
Jan. 26, 1907	900	396
Feb. 14, 1908	807	364
Feb. 5, 1909	1030	457
Jan. 31, 1910	962	489
Dec. 5, 1911	1011	522

The effect of the redeposit system has been to give to the city banks actual control over the fluid funds of the country in very large measure. Naturally this control has centered in New York City. The outcome has been that, without the necessity of controlling the stock of country institutions, large city banks have through the redeposit system been able to exert the practical control of which so much is now heard.

Centralization of Reserves in New York City

The following tabulation shows the growth of the system in New York City, since 1890:

Bank Deposits in New York

Date	Due to National Banks Millions	Due to State and Private Banks Millions
Feb. 28, 1890	$122	$ 48
Mar. 5, 1895	137	63
Feb. 13, 1900	228	108
Feb. 5, 1901	285	76
Feb. 25, 1902	280	78
Feb. 6, 1903	267	72
Jan. 22, 1904	269	72
Jan. 11, 1905	290	83
Jan. 29, 1906	285	88
Jan. 26, 1907	309	84
Feb. 14, 1908	275	71
Feb. 5, 1909	364	94
Jan. 31, 1910	305	100
Dec. 5, 1911	326	106

Exceptional significance should be given to the growth of these items, which show in part the development of relationships between state and national banks. In many places it has come about that the national banks are practically the "bankers' banks" of the region; the state and private banks, trust companies and other institutions depositing largely with them and relying on them for loans and rediscounts when necessary. In truth, the New York banks jointly have come to stand in a relation to the other banks of the country very much like that of the Bank of England to the other banks in London and the country. This, of course, means that the national banks have tended to assume the function of holding the reserve money of the country which is left with them, not only by trust companies and similar institutions, but in many cases by state banks. It is not to be assumed that this is always the case, but in a large number of instances it is so. Moreover, it has been seen, from the statements already made, that the national banks in reserve cities are practically assuming a position in which they hold the surplus reserve of the other national banks of the country, such reserve being more and more closely controlled by city banks. This has been the natural evolution of our banking system in the effort, so far as possible, to economize reserves.

State Banks Deposit In National Banks of New York City

§7. The practice of doing a banking business with other banks has grown extensively within the past few years. At present, small banks the country over, when purchasing paper, keep in mind the possibility of obtaining accommodation from other banks from time to time as they find it desirable to do so. This again is another result of the tendency to economize resources. The small banks buy paper when times are dull at home, in order that they may keep their resources active and earn a fair rate of return for their stockholders from year to year. It is, however, necessary for them to take care of their own customers. Many of these customers are intermittent, or periodic, in the demands they make upon the banks for loans. At times, therefore, it becomes necessary for the banks which serve them to relieve themselves of some of the paper, and thereby secure fluid funds for use as a basis of loans to customers who need such accommodation in their regular business transactions. In order to be sure of a rediscount market for their paper in this way, it is necessary for banks to establish a more or less close affiliation with banks in reserve cities. This re-

Dependence of Small Banks for Rediscounts

lationship permits the reserve city banks to exert a very distinct control over the operations of the smaller institutions. Such control is none the less effective for being indirect and based on no provision of law. The small bank recognizes the necessity of shaping its operations in such a way as to be sure of accommodation from the larger institution. Thus, in another way, a strong tendency towards outside control of the bank's business is set at work.

Another indication of the concentration of control of banking capital is afforded by a study of the changes that have taken place within recent years in the relative numbers of banks of different capitalization organized under the national system. Comparisons cannot be made with absolute fullness and exactness, owing to the introduction of a new class of banks of $25,000 capital by virtue of the law of March 14, 1900. Some interesting inferences may, however, be drawn from the following table:

Tendency to Large Capitalization

Capital of National Banks Classified by Size of Banks, 1870, 1880, 1890, 1900, and 1909

Millions

Year	Total capital of all national banks	Capital of banks with capital less than $50,000	Per cent of total	Capital of banks with capital $50,000 and less than $100,000	Per cent of total	Capital of banks with capital $100,000 and less than $250,000	Per cent of total	Capital of banks with capital $250,000 and less than $1,000,000	Per cent of total	Capital of banks with capital $1,000,000 and less than $5,000,000	Per cent of total	Capital of banks with capital $5,000,000 and over	Per cent of total
1870	....$430	...	...	$14	3.4	$122	28.4	$150	34.9	$123	28.7	$20	4.6
1880	 457	...	...	29	6.4	141	30.9	169	37.1	107	23.5	10	2.1
1890	 650	...	...	72	11.2	198	30.6	218	33.5	150	23.2	10	1.5
1900	 630	$6	1.0	83	13.2	195	31.0	179	28.4	130	20.8	35	5.6
1909	 944	57	6.1	117	12.5	242	25.6	193	20.5	221	23.4	112	11.9
1910	1002	62	6.2	121	12.1	246	24.6	195	19.5	225	22.5	152	15.2
1911	1025	62	6.1	123	12.0	251	24.5	197	19.7	232	22.7	160	15.5

This showing indicates that, while there has been a remarkable increase in the relative proportions of banks of the largest capitalization, there has been a relative decline in the numbers of those of medium capitalization. The small banks of less than $100,000 capital have increased largely, while the same is true of the very large banks, possessing $5,000,000 of capital or over. This points to a growing tendency of banks to drift into two classes, the one with very small capital depending upon the other, possessed of immense capital, for general accommodation.

Under the existing banking system, therefore, it is evident that centralization of control is already on the way to being effected. The situation is one which thus calls for some corrective, if bank independence is to be maintained. Consolidation of banks has gone on rapidly in recent years in nearly all of the large cities of the country, the assets of one institution being taken over by others, the institution thus sold immediately going out of business, or the stock of both institutions being retired and replaced by new issues in specified proportions. The growth in the number of banks of large size cannot, therefore, be regarded as simply the result of the advance in wealth, or of the increasing demand for the services of large institutions, able to make immense single loans to institutions and corporations, but it is also indicative of a disposition to construct these large institutions by using smaller ones as component parts. It is thus more or less an indication of the development of control by large private financial interests over the banking resources of the country.

Centralization of Control

§8. If there were any doubt as to the progress in centralization of control in American banking, it would be entirely dispelled by the results of an inquiry which was ordered by Secretary McVeagh, of the Treasury Department, in July, 1911, in connection with what was known as the National City Bank case. Attorney-General Wickersham, of the Department of Justice, investigated a recently organized New York concern, chartered under state law and known as the "National City Company" of New York. This organization had attracted the attention of the Attorney-General, partly because of its announced intention to own bank stock, and partly because of the fact that it was owned and controlled by a body of stockholders who were nearly identical with the stockholders of the National City Bank, the largest national bank in New York and in the country.

Joint Control Through a Holding Company

Mr. Wickersham found that the company was, as reported, established partly with a view to holding stocks in other concerns, some of them the shares of national banks. He reached the conclusion that a joint control of this kind on the part of a body of stockholders in a national bank who also owned shares in a state concern, the one not to be transferable except as the other was transferred, was inharmonious with the purpose and spirit

of the national bank act itself.* One reason for the adoption of this point of view was found in the circumstance that the National City Company, or any concern organized in a similar way, could be used as an instrument designed to defeat the intent of the framers of the national bank act. The Supreme Court, Mr. Wickersham noted, has invariably taken the view that such joint control is not permissible, and that national banks may not own the stock of other national banks. Attention has been called to this matter elsewhere. If now, he reasoned, they accomplish the same object by reason of an instrumentality created under state law, for the purpose, in whole or in part, of holding the stocks of other national banks, is this not a violation of the plain intent of the national bank act? Reaching the conclusion that it was so, the Attorney-General submitted his opinion to the Secretary of the Treasury, who referred it to the President of the United States.

The National City Co.

The investigation ordered was intended to show how far a similar type of control exists throughout the national system. It resulted in listing the names of about 300 institutions which possessed the same or similar relationship to other banks that existed in the case of the National City Company and its parent institution, the National City Bank of New York.[1]

In this direct and simple manner, there has sprung up in the national banking system a method by which banks may control other banks as far as they desire or have the means, since there is no reason why state institutions, jointly controlled with national banks, may not purchase and hold the stock of any number of other national banks, thereby permitting the stockholders in the original institution to control as many others as they wish or as their means will permit. It is not true that in every, or nearly every, case where this plan has been resorted to by national banks, the affiliation with

Development of Joint Control

*The original announcement of the purposes of the National City Company said:

The board of directors of the National City Bank have decided to form a security company, with a capital of $10,000,000, in which stockholders of the bank may acquire a beneficial interest according to their holdings in the stock of the bank.

This plan has already been approved by stockholders representing considerably more than two-thirds of the stock of the bank. As part of this plan, directors have declared a cash dividend of 40 per cent on the capital stock of the bank, payable July 10 to stock of record July 5. This dividend is declared to facilitate stockholders in acquiring beneficial interest in the security company. Evidence of this beneficial interest will be stamped on the shares of the City Bank stock.

[1]The National City Company has since declared its intent to dispose of its bank stocks.

the state bank or trust company has been brought about for the purpose of owning and controlling bank stocks.[2] This has doubtless been done in some cases. But the fact that there are three hundred instances in which machinery has been devised and set in motion, which would permit such control, is another evidence of centralization of banking authority which should frankly be met. It constitutes a criticism upon the existing situation, and unless provided against, in whatever plan might be adopted for the future, it would constitute a means through which any institution managed by banks as stockholders might be dominated.

Nor is the system of joint control the only indication of centralization effected in this same general way. The investigations of the Comptroller of the Currency during the past year or two have shown that in numerous instances, series, or "chains," of banks are organized and owned by the same group of persons. Sometimes, when banks have been independently organized, a majority of their stock is purchased by persons who already hold the majority of the shares in one or more other national banks. Thus, a community of interest within the national system is established, whereby large banks control and direct the policy of others. Where the subordinate or controlled banks are themselves influential factors in a local banking group, as, for example, in a clearing-house association, the actual and real control exerted may be very much more extensive and powerful than the purely nominal control obtained through direct ownership of stock. In such cases, a nucleus is formed for the extension of banking influence over a considerable area, or over a considerable group of financial institutions.

"Chains" of Banks

No figures are available in published form to show precisely how extensive this type of control is, but it is an undoubted fact that it has already gained a substantial foothold. This is attested by the inquiries of the Comptroller of the Currency, and by commonly known and observed facts concerning inter-bank control in well-known instances.

A New York bank, for example, gains control of smaller banks in Washington and at various southern points, through the purchase of stock in such institutions by directors or controlling stockholders of the New York concern. It is then in position to

Extent of Control By Chains of Banks

[2] In some states, as, for example, in Illinois, the statutes expressly forbid the holding of bank stocks by other banks.

direct country deposits toward itself and to exert a general control, not only over the institutions whose stock is owned, but also over those which are tributary to the owned or controlled banks. In this way, networks of banking influences have been allowed to develop and spread over the country, to what precise extent cannot be stated, although their scope is unmistakably large.

There is nothing in existing law to interfere directly with the growth of this kind of control, and should a new system of coöperation between banks be established for the purpose of economizing reserves and supplying discounts, it must be done in such a way as to avoid the danger of undue influence which could make itself felt through the extensive voting control obtained by national banks in the way already indicated. Moreover, this system of control is by no means limited to the national system, although it has been more carefully studied there. Extensive inter-bank relationships of a like kind are known to obtain in many of the states, small trust companies and state banks being, in practical effect, branches of other and larger institutions.

A Remedy Needed

§9. There is another way in which centralization of control under present conditions has been greatly forwarded, and in which outside financial influence over liquid funds has been strengthened. This is found in the relation of the government to the banks. Under existing law, government revenues are paid in to the Independent Treasury, which holds them in actual cash. The Treasury, however, cannot hold these funds long in any great quantity, without doing serious harm. It, therefore, will wish to put them back into circulation as soon as may be, in order that there may be no shortage of reserve money due to its withdrawal of funds through the receipt of revenues and through the failure to pay out an equal amount in current disbursements.

Control Furthered by Government Deposits

Such a return of the funds to commercial channels is usually effected under existing law by making government deposits in national banks. These deposits are protected by requiring the banks to leave with the Treasury, bonds of specified kinds, which might be sold in the event that the failure of the depository bank should expose the government to the risk of loss. The bonds may be owned by the banks which deposit them, or may be borrowed from others, but in any case, they are turned over to the Treasury, and title is transferred, in order to protect the government.

Protected by Bonds

There is no criticism upon the system of protection, but very severe criticism must be made upon the way in which these deposits have been made in the past. In ordinary times, such deposits have been distributed largely upon a political basis, the attempt being made to apportion them somewhat according to population, geographical distribution, or bank capitalization. Not infrequently the distribution has been made, also, by political pressure. In this way harm was done, because banks received control of funds which did not normally arise in their own communities and which were drawn from some other community that had acquired control of them as the natural result of its commercial operations, often in places and under conditions where trade was the greatest.

Undesirable Distribution of Deposits among Banks

In times of panic or stringency, however, the situation has been even less satisfactory. On such occasions, the government has often been driven to placing its funds in large blocks with the banks in the principal cities. It has sometimes appeared that the reason why some of these institutions were in such great want as to require relief was that they had been making excessive loans for speculative purposes. When speculation threatened to break down, relief could be had only by getting more government funds. In such cases, it would often be unwise to withdraw or curtail the speculative loans, inasmuch as such action would result in commercial depression and disaster. On these occasions, therefore, the action of the government in depositing largely with banks in the larger cities, "in order to relieve the market," has been equivalent to the placing of government funds at the disposal of speculators who were permitted to use them for their own purposes. This course of action could not be justified upon any grounds save those of necessity—a necessity growing out of the peculiar organization of our banking and credit system at the present moment.

Deposits to Relieve the Market

§10. It has thus been evident for a good while that the system of nominal competition established under the national banking system was not real, and that actual centralization had developed because of the weakness of the smaller banks and their necessary recourse to others in times of special strain. Only the defects of the competitive system in banking have been retained—the weakness of reserves, the inability to accommodate borrowers, and the susceptibility to panic. The facts in the situation have been long

perceived, even if only subconsciously, by the banks, and it has been recognized that the evils of the system could be corrected by the use of some plan of coöperation, without a resort to legal centralization in banking. It was seen that the most expedient and easy way to introduce into the United States the superior safeguards and more advantageous methods found in foreign systems of banking was not the mechanical adoption of some legislation of doubtful utility and dangerous suggestion, but rather that of effecting a closer coöperation among the banks themselves. Efforts to get such coöperation have taken very definite form.

Failure of Competition to Prevent Centralization

The best and most natural step was the organization of associations of banks called clearing-houses. As we have elsewhere seen, the first of these was established in New York in the year 1853, but this did not long remain an isolated example. Informal conferences and associations of banks early came into existence in many places, and at present there exist formally organized clearing houses in about 137 localities.

Resort to Coöperation Necessary

So successful were these clearing-houses in their work of coöperation at periods of stringency, that they were later able to afford a lesson in practical legislation. The Aldrich-Vreeland Act, passed in 1908, sought to apply, through the organization of "national currency associations," the same methods of mutual aid which had been developed by the clearing-houses. But the Aldrich-Vreeland Act has been thus far practically a dead letter, and the clearing-houses in their exercise of credit functions have continued to be merely temporary expedients. Whenever the period of worst danger has passed by and the community has reached a calmer mood, they have been disposed to "stand from under," and at times this has resulted in forcing a number of weak banks to the wall. It would have been well if the coöperation had begun early enough to prevent such banks from becoming weak, or had continued long enough to enable them to recover their solvency; but under a purely voluntary system of coöperation, neither of these desirable objects could be gained.

Currency Associations

Moreover, the banks hitherto have never been able to obtain by joint action any satisfactory method of controlling reserves or economizing the use of funds, and of course they have never had any means of regulating the flow of gold and silver into and out of the country. That could be accomplished only by coöperative action of a very close and well-defined type, or else by the action

Coöperation under Present System Limited

of some central institution acting as a reserve-holder for the country and recognized as the leader of the financial community. There is nothing to indicate that any of these objects can, or will, be obtained under the present system.

Coöperation or joint action on the part of the banks has evidently gone about as far as it is likely to go. There are few or no particulars in which it seems possible to draw the relationship between the institutions closer than at present. This implies that, if anything is to be done in securing better joint action from the banks, it will have to be accomplished by some plan of federation in which, while preserving their own freedom and individuality, they will join under legal forms, for the purpose of promoting the interests of the banking system of the country as distinct from that of each individual bank. The experience of other countries, as already noted, shows that these results may be obtained, either through the establishment of a central institution or through coöperation. Our own experience points to coöperation as not only the line along which voluntary development has been proceeding, but also that which holds out the easiest and most promising avenue to the attainment of the safeguards and convenience realized by foreign banks.

A Central Bank Impossible in the United States

The universal testimony of those who have studied political and economic conditions in the United States is that a central bank, in the sense in which such institutions exist in Europe, is not only impossible but undesirable. Such an institution, privately owned, would be regarded with suspicion by the public. Our own experience during the first fifty years of American history with such an institution was unfavorable from the political standpoint. It is seriously to be doubted whether such an institution could, as a matter of practical legislation, be obtained again. And there is the best of reasons for questioning whether a bank of this type would be desirable, even if it could be chartered. The large institutions of Europe are successful, partly because they have a recognized place in the community, which has been gradually developed through long years of custom and tradition. They stand in a peculiar relation to the governments of their countries, which is feasible because of the types of administrative control which exist there, but which would not be feasible with the types of administrative control which exist here. European countries are much smaller than our own and their commercial systems are organized

about a few well-recognized financial centers. They do not present the same widely divergent types of climate, industry, population and competition that are included within the United States. This means that a central bank, if established here, would have a decidedly different problem to deal with from that which is presented in any of the European countries. Nothing would be more unwise than simply to copy the external features of a European banking system without having the basis for it which makes it successful. It has been said with justice by some critics of the so-called "central bank" plan, that if we were to adopt that system in the United States, we should need not one, but several "central" banks. It is at all events quite clear that a single central institution, privately owned, and similar in its nature to the great government institutions of the present day, or similar to the two great banks which were chartered by the United States during its first fifty years, could not be created to advantage.

European Precedents

It has been suggested that the government itself should perform banking functions, accepting the duties which are met by the large central banks of Europe, and in some way holding the reserve of the country and extending accommodation to bankers who might desire it. This scheme has never assumed any distinct form, and is too nebulous to warrant very serious discussion. This point, however, will be given more complete treatment elsewhere. It should be said, however, that no government bank is likely to be satisfactory or efficient in the United States, and that such a scheme is too hazardous, under our political conditions, to be considered for a moment. Practically, then, there remains merely the question whether some reorganization of American banking that will meet existing difficulties and permit coöperation is possible. The natural way in which to work out this sole method of reform is through the application and development of the methods already resorted to in a rudimentary way by the banks. The problems involved in bringing about such a result may now be briefly noted.

A Government, or Treasury Bank

§11. The fundamental necessity in introducing a regime of coöperation among the banks is that of regular and organized legal coöperation. As has been seen, all forms of coöperation thus far have been informal. True, to national currency associations has been given a legal existence, but their operation is sporadic and purely

voluntary. These two things condemn the National Currency Associations and limit their usefulness to exceptional periods of crisis or stringency. We do not want a "panic currency," or any means of "relief." What is wanted is steady support that will render relief unnecessary, and will prevent the recurrence of stringency calling for such relief.

Permanent and Continuous Coöperation Necessary

In order to get this sort of continuous and sustained coöperation among the banks, it is evidently necessary to establish some institution with a definite capital which will be in continuous existence, applying itself regularly to the duty of supplying bank credit as needed. By whom should such an institution be owned? There is, as noted, abundant reason in political conditions why it will not be feasible to place the ownership of such a concern in the hands of private individual stockholders, even if it be rigidly supervised, and perhaps in part owned by the government itself. We have also indicated briefly why the stock cannot all be owned by the government itself. This leaves only the banks themselves as possible stockholders. If they were to be called upon to organize an institution in which all banks could share, they would be entirely freed of any fears of undue outside competition. They would know that a minimum of profit would be redistributed among them equally; and, more important still, they would know that such an institution could be conducted in a way that would give due consideration to every stockholding bank. The public would thus be assured of receiving ultimately the benefits from the operation of such an institution, inasmuch as free banking would continue and competition between banks would be as keen as it now is. This would imply that every bank, whenever organized, should be permitted to become a stockholder in the new institution. The organization could, therefore, never become a monopoly.

Capital Should Be Supplied by the Banks

If every bank, whenever organized, were permitted to take out a specified amount of capital stock in the concern and, whenever it went into liquidation, were to be compelled to surrender its stock, the organization would have an outstanding capital corresponding, in a fixed proportion, to the total capital of the banks of the country, and increasing as that increased and diminishing as it diminished. The advantages of such an organization would be, while preserving their individuality, to give a definite and fixed relationship to the banks that were members of the organization, with reference to their coöperative functions, and to place them in

Organized Legal Coöperation

position to get the direct benefit of joint action. The creation of such an institution would imply that a sufficiently large capital had been contributed by the banks and had been made available as a basis of business operations. That such capital could be made to earn a fair rate of return for those who supplied it, there is no reason to doubt, while the gain in permanence and stability for the coöperative organization would be far superior to any mere earnings that the institution might produce.

Such An Agency Should Deal Only with Banks

If such an institution were to be genuinely coöperative in its functions, it should necessarily be so restricted in the classes of business it could do as not to compete in any undue way with the banks that had become stockholders. The first limitation upon its business, then, would be that it should not deal with individuals at all, or only under very carefully described circumstances. Its business should be limited in the main to dealings with the banks that had established it. This would signify that all testing of paper presented for discount, and all determination of the amount and character of loans, would be effected in the first instance directly by the several banks that held stock. After such banks had acquired commercial paper or made loans on securities, they would be in position to do business with the coöperative association. This business would consist primarily in rediscounting the paper which had been created in the way already described. A few other classes of business would probably also be undertaken, as will be seen later.

Also Create Market for Commercial Paper

In performing this rediscount business, the coöperative institution would afford a permanent and constant market for commercial paper. *If the banks could secure better accommodation from one another, there would be no reason why they should not do so.* The coöperative institution would make no effort to compete with banks which were disposed to discount the paper of others. But, in those cases where banks preferred not to sell their paper to others, or where rediscounts were refused, or where the transactions proposed were so large as to be beyond the reach of the banks which were asked to buy or rediscount paper, the new institution would afford a stable, regular market. In so doing, it would provide a means of escape from all danger of bank favoritism, and from any discrimination that might otherwise exist among institutions as under the present system. *Its operations would be carried on upon a basis of equal opportunity for all and upon equal terms*

to all. Not competition, but the rendering of assistance and the promotion of convenience, would be the duty of the new institution.

§12. It is probable that, with such an organization as has been described, there would be developed a very strong tendency toward economizing and conserving the stock of reserve money in the country. This would mean that the stockholding banks, by depositing their funds with the association, would not only provide themselves with resources upon which to draw in normal times upon the principal financial centers, but also, they could feel assured, under the rigid restrictions by which the concern would be controlled, that their funds would be available whenever they might wish to use them. This would be rendered possible by the grant of much more liberal powers of note-issue than are now conceded to the national banks, and by much greater economy in the distribution of the reserve funds. It is proposed that the various banks should be subject to much the same reserve requirements as at present, but that in counting their reserves, they should be allowed to include such credits as they had secured with the National Reserve Association, or coöperative institution, as described. This would mean that in practice, banks would keep in their vaults only those amounts of actual currency which were required to meet current calls for cash.

Economy of Reserves

As will be seen elsewhere, the proposed plan calls for the ultimate absorption of the power of note-issue by the National Reserve Association. That being the case, a bank which found itself running low in reserve funds, would supply itself, not by calling upon some other bank in another city for actual lawful money, nor by borrowing bonds and securing, after considerable difficulty, an issue of notes through the Treasury Department, but by simply taking such live commercial paper as it might have to a local association of banks, or direct to the local branch of the National Reserve Association, and obtaining a rediscount. Under such conditions, the banks would not care to keep on hand very large quantities of coin or government notes in their vaults. Instead of hoarding these resources as they now do, they would place them where they would be most convenient, that is to say, with the National Reserve Association.

No Need to Ask Other Banks for Reserve Money

No Hoarding

The Reserve Association would be required to keep on hand an ample supply of coin and government notes for the purpose

of meeting actual calls for money and currency. Probably the amount of reserve the institution should thus be required to keep, under normal conditions, should not be less than 50 per cent in lawful money. In order to insure that this reserve requirement should not be a rigid limitation which would prevent the Association from granting the discounts that were needed, it should be provided that the Association might let its reserve run down, provided that for each unit of decline there should be a tax increasing proportionately as the reserve fell. This would mean that while the Reserve Association would probably be willing to discount first-class paper, even if its reserve were at or below the 50 per cent line, it would not be willing to do so without charging an extra rate of interest. If it charged such a rate of interest, in addition to the commercial or going rate, banks would hesitate about demanding rediscounts. They would call for them only when they felt a genuine necessity for an increase of credits with the Reserve Association; that is to say, for an increase of what would to them be reserve money.

Check on Declining Reserves

It can be seen that the effect of this system would be (a) to reduce the actual lawful money held by the banks in their own vaults and to transfer this lawful money to the Reserve Association; (b) to make it possible for banks to obtain all needed additional credit (which to them would be reserve) by paying sufficiently high rates of interest at the National Reserve Association offices; (c) to induce the National Reserve Association to keep its reserve at a safe point by compelling it to bear the burden of heavy taxation upon all shrinkage below 50 per cent. Thus the stock of money of the country would be economized. More than this, the stock of money would be shifted to those points where it was wanted. When banks did not need large reserves, they would not call upon the Reserve Association for rediscounts; they would keep the cash reserves in their own vaults, or deposit them with the Reserve Association, but without asking for accommodation. Other banks in other parts of the country might at the same time be suffering from some stress. If the Reserve Association were well supplied with funds left with it by banks in regions which did not need accommodation, it would, by reason of this abundance of resources, be able to extend credit cheaply to the outlying banks whose resources had run down.*

Gains from Coöperation in Economizing Reserves

*This institution would then, in its own way, provide for remote parts of the United States all the advantages that accrue to Canada by their system of branch banking.

Only in case of a pretty general stringency, resulting in a call for accommodation everywhere, would the reserves of the National Reserve Association run down to the line mentioned, and result in the levying of a tax of an amount proportioned to the reduction below 50 per cent.

National Reserve Would Serve the Banks as the Banks Serve the Public

§13. In what has been said thus far, constant reference has been made to "rediscounts" as being the kind of business that would be done by a coöperative institution or a National Reserve Association. It is now time to indicate more precisely exactly what classes of business could properly be undertaken by such a coöperative institution, with the design of supplementing the work of the banks, while at the same time avoiding undue competition with them. Evidently such transactions would necessarily exclude the idea of dealing direct with the commercial public which makes the paper that is offered to the banks—certainly in all except a very restricted number of cases. This must mean, then, that kinds of business offered to the coöperative association would be those which had already been offered to, and accepted by, the banks which were authorized to deal with it. In essence, then, the coöperative function of the association would consist in purchasing from the banks the paper which they had already acquired—that is to say, the Reserve Association, acting as the representative of all the banks in the country, stands ready at any time to relieve any bank of paper in its possession, provided such paper is of approved kinds, thereby turning its resources back into a liquid form, and performing for it exactly the same service which it performed for its original customer. Theoretically then, the Reserve Association would be a bankers' institution, and its relation to banks would be like the relation of the banks to the public.

But just here it should be asked whether the Reserve Association ought to do all the kinds of business that are done by the constituent banks; that is, should it stand ready to purchase all the classes of paper which are purchased by the several institutions? If not, then what limitations should be placed upon the business of this coöperative institution? The kinds of paper which the Association may properly deal in can be made clear by remembering that the function of the institution is to serve the commercial public. This implies the use of certain standards in the selection of commercial paper. Such paper must be (1) abso-

lutely sound; (2) running for short periods only, and therefore liquid; (3) the product of commercial transactions strictly—in other words, the outcome of transactions undertaken for agricultural, industrial or commercial purposes. Following such tests, the institution would ordinarily be absolutely assured of the soundness of the paper presented to it. The prime paper of firms recognized as of high standing, if of short maturity, could be directly rediscounted for a bank at a branch of the Association. Moreover, it ought not even to run the risks that are naturally and properly incurred by a single bank in the course of business. Such assurance might be obtained through the guarantee of paper presented to it by a group of banks formed in a local association in any given section of the country. Supposing that such a National Reserve Association as is here described were to be organized with branch offices, these offices would act as the agencies for rediscount, and could be assured of the goodness of the paper presented by any bank, provided that it was backed by the guarantee of other banks in the neighborhood and having knowledge of the local conditions. Here would be one type of paper of unquestionable soundness.

Tests of Sound Paper

If Guaranteed by Local Banks

Or, the Reserve Association might purchase the acceptances of banks or acceptors of unquestioned financial responsibility, arising out of commercial transactions. Thus, by an arrangement entered into between a bank and its customer, a buyer of goods, a bank might be drawn upon by the seller of goods for, say, sixty days. The bank would accept this draft. The seller could then discount this bill at his bank. The second bank could offer it for rediscount at the Reserve Association. This paper—a prime acceptance—would be of exceptional soundness, because it would bear the acceptance of one bank and the endorsement of a second. Here would be a second class of business in which the Association might engage. It would be a class of business in which national banks cannot now engage, because of legal restrictions.

Acceptances

Evidently similar transactions in foreign exchange, guaranteed in the same way, should fall within the scope of the Association, and likewise transactions in gold coin and bullion, and, under proper restrictions, in public debt. In order to keep all these transactions and the resources of the institution constantly liquid, the period for which any of this paper could run should necessarily be short. How short it would be must necessarily depend upon the

Foreign Exchange

commercial practice giving rise to that particular class of paper. From 30 to 120 days would be the scope of time covered in the various kinds of transactions of the institution.

Stock Exchange Loans Excluded

Nothing has been said thus far of excluded transactions except by implication. It is clear, however, that two chief kinds of operations would fall without the scope of the Reserve Association: (1) those involving long-time loans, and (2) those involving a speculative element. This restriction would necessarily shut out loans upon stocks and bonds and collateral security of the same kind. By limiting the business of the institution solely to commercial paper, and shutting out absolutely paper based upon doubtful or speculative transactions, the institution could be made a coöperative agency in the highest sense of the term. It would deal only in those kinds of paper that are clearly and unquestionably common to all banks, and it would refuse those classes of paper that are rejected by any class of legitimate banks. Under rigorous conditions only, would it rediscount loans made even on high-class bonds and collateral as security. It would, in short, confine itself to those operations that were unmistakably and obviously legitimate banking transactions. This would mean that no operation could be undertaken which would be regarded by outside bankers or merchants with doubt or question. Only those transactions could be undertaken which were clearly for the benefit of all the banks to have carried on, and at the same time for the benefit of the business public. Thus, all responsibility of using the consolidated power of the Association for the purpose of promoting the interests of any given institution or of any group of clients of such institutions, would be rendered impossible. The coöperative function would be seen in the use of the funds of all the banks to facilitate and promote the performance of those transactions in which every commercial bank is engaged.

Confined to Business Beneficial to Both Banks and Public

§14. In such a plan as has thus been set forth, there would be no compulsory element. No bank need avail itself of the facilities held out to it unless it felt so disposed. It would not be obliged to do business with the Reserve Association if it could get better terms and conditions elsewhere. If, in ordinary times, the methods that have been employed in the past sufficed, banks could avail themselves of these methods in the future exactly as they do now. But the Association would afford an additional

Membership Voluntary

means of relief and protection, not previously offered, at the same time that it would furnish entire protection to the banks against any additional competition in doing business with the public.

It would probably be found that much business in the way of rediscount, not acceptable to the Reserve Association, would continue to be handled by the individual banks which transact such business at the present time. If that were done, there would merely be a differentiation of function between the Reserve Association and the banks which now do a large discount business. There would probably be a great growth in business, and the resources of the banks, economized and strengthened by mutual support, would be called into use in many directions where they cannot now be successfully employed at all. In that case, the business done by the Reserve Association would be simply so much clear gain, since it would represent additional transactions that could be financed by the banking system of the country with safety.

More Business Could Be Safely Done

By thus enabling existing banks to take care of a larger volume of business successfully and at lower rates, the actual expenses of banking would be greatly reduced. The banks would find that they could lower their rates of interest very materially to borrowers for commercial paper of the best class, and by so doing they would stimulate the development of such paper. Coöperation, by producing division of labor in banking, would increase earnings. There is probably no institution that would not profit continuously and regularly from the establishment of the proposed Reserve Association. They would, moreover, be saved the serious losses which are entailed as a result of periodical crises, or stringencies, in which the institutions are obliged to reject business because they cannot safely provide for or take care of it. This, then, would be the chief agency in assuring coöperation—that such coöperation was profitable and resulted in greater success than could be obtained without it. Competition would in no way be impaired or interfered with; on the contrary, it would tend to be increased, since the expenses of bank operation would be reduced to a lower and far more systematic basis than under the present system.

Earnings Would Be Increased

Simultaneously with this beneficial result of coöperation among the banks themselves, there would be produced a most desirable effect upon the commercial public of the country. The

public would find that, through the ability of the banks to rediscount with the Reserve Association, the opportunities for obtaining accommodation were greatly increased, provided that the paper offered was of first-class character. This would mean that the man having such paper could always be assured of a satisfactory supply of capital and could get this capital at the lowest rate. It would not be necessary to employ middlemen to float commercial paper to anything like the extent that is now practiced.

Credit on Good Paper Always Available

In another way, the operation of the proposed institution would produce nothing but benefit. At present, there are too many banks that accept the paper of commercial houses somewhat independent of its liquidity. The result is that in some cases bank funds are "tied up," and the institutions are not able to extend the credit that they otherwise would be able to grant to business concerns which do not stand in close personal relations with the bank managers, but which, nevertheless, have first-class paper to offer. This is an injury to the legitimate business of the country, and necessarily impairs the development of those business concerns of high standing that depend largely upon bank credit to finance their operations. As no business doing a large volume of trade can get along without extensive bank accommodation, the effect of such conditions is to limit the scope of commercial transactions. With this difficulty removed, and with a broad national market for paper growing out of actual commercial operations, the resources at the disposal of legitimate and active firms would be far greater than now.

Advantage to Commercial Borrowers

Summary

§15. The characteristics of the present banking system are division of energy, lack of concentration of banking power, and scattering of resources.

These evils can be overcome only by joint action or through the powerful control of some large central bank. The latter is undesirable and impossible so far as the United States is concerned. The establishment of some coöperative association designed to consolidate and economize banking resources would overcome the evils now suffered.

Such an association could be obtained by federating the banks in an incorporated organization, endowed with sufficient capital, and authorized to perform operations that are for the good of all.

The operations which the institution should thus perform are those connected with the rediscounting of certain classes of paper. These classes are those which grow out of actual commercial transactions.

The performance of such a service for the banks would not subject them to outside competition, but would enable them to compete more successfully and regularly with one another for the benefit of the commercial public.

By properly limiting the activities of such an institution, its funds could be kept entirely out of the hands of those persons who might wish to use them for speculative enterprises.

Such an institution would be found in a National Reserve Association possessing functions of the kind described.

CHAPTER XIII

CONTROL OF THE RESERVE ASSOCIATION

1. The Fear of Making Present Bad Conditions Permanent—2. A National Reserve Association—Possibility of Keeping it Free from Speculative Influences—3. How to Prevent Concentration of Fund—Active Business at the Branches—The Local Association the Unit of Control—Control of Branches—4. Directors of National Reserve Association and How Chosen—5. What is Meant by "Control"—6. Possibility of Control of Reserve Association Discussed—7. The Idea of Control Through a Holding Company—8. Publicity and a Free Banking System as Safeguards—9. The Question of Share Influence—10. Possible Control Through Favor—11. Geographical Control and Sectional Opposition—12. Unity of Banking interests—13. Political Control and the Evil It Would Work—14. To What Use Could Control of the Reserve Association Be Put?—15. Control of Other Banks Would Not Interest Bankers—16. Safety Through Establishment of a Market for Commercial Paper—17. Why Large Banks do Not Oppose Reserve Plan.

The Fear of Making Present Bad Conditions Permanent

§1. At the present time a method of centralized control has a more or less secure foothold in the banking system. If left undisturbed, the tendency to centralization will be likely to go on increasing and may lead to unfortunate results. There is nothing to check this tendency under existing conditions, and it is doubtful whether merely prohibitory legislation could be enacted that would eradicate it. The evils of the existing system of inter-bank control have been very keenly felt in many quarters. Nowhere has this been more truly the case than among the small banks and their customers, who have suffered from its effects.

As a result of this critical attitude there has sprung up a natural feeling of hostility to what is called "centralization," because it is supposed that with such centralization there would be a much higher degree of control on the part of large banks over small banks than is exercised at the present time. It is feared that proposed legislation would consolidate or petrify existing conditions and add some further elements of the same sort which would aggravate the troubles now complained of. This fear is founded upon the distinct recognition of existing evils. But it should be understood that legislation on banking in the United States ought to be adopted

for the purpose of ending these conditions. Knowing as they do that the conditions from which they are suffering today are the result of extra-legal arrangements between banks, the smaller institutions feel that it is still possible to remedy such harm as may exist at the present time, by the introduction of legislation designed to terminate it, or by the gradual growth of better methods of banking practice. The question is not merely negative; it does not imply simply the demand that nothing shall be done to aggravate unfortunate conditions. It is rather a positive issue and its significance is the demand for legislation which shall actually improve the present banking mechanism and remove the possibility of any coming centralization.

The Federal government could not pass legislation which would be applicable to the banking systems of the several states, even if it desired to do so. It is, however, possible for the Federal government to correct existing conditions in two ways: (1) by providing inducements to banks to abandon or refrain from such alliances; and (2) by the removal of those conditions in the banking system which have tended to establish and confirm the drift toward inter-bank control. The new legislation should be of a kind that would end the system of dependence which exists among the banks and should at the same time render inter-bank control absolutely out of the question. That is the object which is sought by those who believe in a coöperative banking institution, or National Reserve Association. It should be a primary object of this institution to bring about a condition of entire independence on the part of the banks by supplying them from the Association with such aid and support as they may need in the conduct of their legitimate business. It should seek to put an end to any conditions that would permit the further development of present day tendencies toward banking combination. The plan for new banking legislation must be absolutely tested by its success in providing effectually (a) against inter-bank control through stock ownership or stock manipulation; (b) against inter-bank control through the granting or withholding of favors or through any subterranean influence; and (c) against the control of banks by ambitious politicians who wish to use them, or such new banking mechanism as may be established, for their own purposes.

Desired Intent of New Legislation

Tests of Desired Legislation

If these objects can be gained by legislation, the banks of the country would be freed from the necessity of depending upon, or asking favors of, other banks, and their customers would be relieved

of the cost and inconvenience entailed by the present system. The advantages of coöperation as sketched in an earlier part of our discussion would be theirs and they would be protected against any control or monopolization of these advantages by large banks, by speculators, or by any outsiders whatever. This plan aims to avoid the further development of the danger of ambitious financial control by eliminating the conditions which tend to produce it and by offering every inducement to banks to join, upon a strictly and entirely independent basis, in a system of coöperation which will leave them in position to carry on their own business, in their own way, without being subject to the influence of other institutions.

§2. The plan of a national reserve association is so framed as expressly to avoid influences originating in speculative markets and tending to divert bank resources from commercial, into financial or speculative, channels. The plan is to create a coöperative institution called for convenience the National Reserve Association, its stock held by banks, its customers to be solely or almost solely banks seeking accommodation, and its control to be so localized that in every part of the country bankers will feel that a direct power in the management of its affairs vests in themselves. The plan as elsewhere outlined (Chapter II) would provide for an institution with, say, $200,000,000 of capital to be taken up by national and state institutions in proportion to their own capitalization.

A National Reserve Association Plan

Would it be possible to keep such an organization free from speculative influence and to insure that the banks' funds should be used for their own benefit and that of the communities in which they were situated? To suppose that the attainment of such a purpose is impossible would be merely to assume that correct organization for the accomplishment of a very simple end would be impossible. It it could be demonstrated that, whatever plan might be adopted, its ultimate purpose would be to facilitate local business, and that its method of control would safeguard the individual banks and the community against exploitation, then there would be perfect assurance of freedom from such speculative influence. The only problem would be that of working out the details.

Possibility of Keeping It Free from Speculative Influences

Such details of management might possibly be developed in any one of a number of different ways designed to attain the same object.

In the plan for a National Reserve Association now before the

country the effort is to provide a regular and legitimate means of coöperation among the banks whereby they may obtain the strength which comes from united effort, and may be relieved of the burden which falls upon isolated institutions when they can get no aid in times of special stress or anxiety. At the same time the plan of the National Reserve Association is to secure, if possible, the general public benefits arising from the combined use of bank funds in the most efficient and economical way under restrictions and limitations which will absolutely prevent any group of persons from taking the advantage to be had from the employment of bank funds for the promotion of their own special enterprises. In other words, it wishes to secure all the benefits of strength and easy distribution of credit which are to be derived from a coöperative plan, while assuring the distribution of these benefits to the public generally by means of rigid control over bank operations. Coöperation, not centralization, is the object aimed at and the results are to be those of joint effort and responsibility, not those of individual or central control and responsibility.

Coöperation is for the Public Benefit

§3. In carrying out this enterprise two classes of difficulties must be met—those relating to the too great concentration of funds, and those relating to the too great personal influence of strong men in the financial world. To guard against the first class of dangers, the National Reserve Association plan provides for the operation of a series of branches and of local bank associations. The branches of the institution will be the scene of its principal operations. The head office, located in Washington, a non-commercial city, will be chiefly a central place of record and oversight. The active centers of operation will be in the branch offices, which are to be located at fifteen different points distributed fairly throughout the country. Not centralization, then, in the ordinary sense of the word, but coöperative action at fifteen principal business centers, these joined together for the purposes of mutual aid, is the plan in mind. Under the proposed scheme, each of these branches would do simply a rediscount business. Paper of restricted kinds could be presented to them by local associations of banks and by individual banks under certain specified conditions. This paper would then be rediscounted, and every bank applying for rediscount accommodation would thus be able to get advances which now it is obliged to solicit from the correspondent banks

How to Prevent Concentration of Funds

Active Business at the Branches

with which it does business. Under the proposed system it could demand the desired accommodation as a right, if the paper offered were unexceptionable.

In order to provide for full control by local banks over their own affairs in relation to the National Reserve Association, all subscribing banks would be grouped into associations to be designated as "local associations." Each such local association would have corporate powers and would be composed of not less than ten banks, while the combined capital and surplus of the members of each local association would aggregate not less than $5,000,000. Such local associations would be generally grouped within one of the fifteen divisions, to be called districts. Within each district the territory would be so apportioned that each bank would be located within the boundaries assigned to a local association, and every bank which was a stockholder in the National Reserve Association would be expected to become a member of the local association comprising the banks in the locality in which it is situated. Thus, in every one of the fifteen districts covering the whole country, there would be a number of local associations arranged according to convenience. The number which could exist in any one district would depend upon the amount of the total capitalization of the banks in that district and their number, as compared with a capitalization of $5,000,000 and the number ten, these constituting the minimum size of a local association. The local association would thus be the unit for the control of national reserve affairs within the district in question. Its management would, therefore, be the really important and significant feature in the whole organization of the National Reserve Association.

The Local Association the Unit of Control

There might be various methods of choosing a board of control to manage a local association, but the one which would probably be of greatest advantage would be as follows: Each local association would determine upon a number of directors to manage its affairs, which should be either five or some multiple of five. Of this number, three-fifths could be chosen by ballot cast by the representatives of the banks that are members of the local associations. Each bank would have one representative and each representative one vote, without reference to the size of the bank. Two-fifths of the whole number of directors would be chosen by these same representatives of the several banks that were members of the association, but in voting for the additional directors (the two-fifths), each representative would be entitled to as many votes as

Government of Local Association

the bank which he represented held shares in the National Reserve Association. Here would be a method of choosing a Board of Directors in which each bank would be assigned due weight, independent of its capitalization, since, in making the choice of men, each bank would be allowed a vote for three-fifths of the directors upon a perfectly equal basis with other institutions.

One Bank, One Vote

The plan would also allow some influence to banks in proportion to their ownership of shares in the National Reserve Association; but it is to be noted that this influence of banks in the choice of directors on a basis of share ownership would be limited to two-fifths of the directors in all. The fact that a bank was an independent institution would thus count for more than its share ownership in determining the composition of the Board of Directors. These directors when thus elected would annually choose the usual officers, a president, a vice-president and an executive committee, whose powers and duties and terms of office should be determined by the by-laws of the local association. In these by-laws would be provided a method of filling vacancies on the boards of directors. The main restriction imposed upon the directors would be that no director should at the same time be a director of a branch of the National Reserve Association.

By-Laws of Local Associations

Of course, the method of controlling the branches of the National Reserve Association, one of which would be located in each district, would be equally as important as that of the local association itself. Let there be at least twelve directors. Probably the best plan would be that each local association should select by ballot a voting representative. One-half of these directors might be elected by representatives of the banks, each representative being entitled to one vote without reference to the number of shares his association holds in the National Reserve Association. One-third of the directors might be chosen by the same representatives, each representative having a number of votes equal to the number of shares in the National Reserve Association held by all the banks in his association. In order to bring the directorate of the branch into close connection with the business life of the community, it is supposed that in addition to these directors there should be added a number equal to one-sixth of the total number of directors, such additional directors to be chosen by the already appointed directors and to be selected in such a way as to represent fairly the industrial, commercial and agricultural interests of the district, none of them being officers of banks, or financial institutions.

Control of Branches

Non-Banking Directors of Branches

If this plan were carried out, the Board of Directors of every branch of the National Reserve Association would contain the following elements:

Summary of Branch Directors

(1) A group of directors not less than six in number, chosen by the directors of the local association, each association having one vote.

(2) A group of directors equal in number to one-third of the whole number of directors and elected by stock representation.

(3) A group of directors equal in number to one-sixth of the whole, representing the industrial, commercial, agricultural and other interests of the district, and elected by the votes of the first two groups, each director thus voting having one vote.

(4) If the manager of the branch were added, as he necessarily would be, he would be *ex-officio* a member of the Board of Directors of the branch, and should be chairman of the Board.

The members of the Board thus chosen, except the chairman, should be classified at the first meeting and should hold office according to classes, for one, two and three years, respectively, all succeeding directors being chosen for periods of three years in each case.

§4. What has been said thus far relates entirely to the question of local control—that is, the control of the local associations of banks and of the branches of the National Reserve Association. Nothing has been said of the methods by which the central board of directors controlling the Reserve Association as a whole is to be chosen and managed. The Board of the National Reserve Association would consist of forty-six directors, and would be composed in the following manner under the Monetary Commission's plan:

Directors of National Reserve Association

First. Fifteen directors shall be elected, one by the board of directors of each branch of the National Reserve Association. In case the number of districts shall be increased hereafter, each additional district shall be entitled to elect an additional director of this class.

Second. Fifteen additional directors shall be elected, one by the board of directors of each branch of the National Reserve Association, who shall fairly represent the agricultural, commercial, industrial, and other interests of the district, and who shall not be officers, nor, while serving, directors of banks, trust companies, insurance companies, or other financial institutions. In case the number of districts shall be increased hereafter, each additional district shall be entitled to elect an additional director of this class.

Third. Nine additional directors shall be elected by voting representatives chosen by the boards of directors of the various branches, each of whom shall cast a number of votes equal to the number of shares in the National Reserve Association held by banks in the branch which he represents. Not more than one of the directors of this class shall be chosen from one district. Directors of each of the three classes named above shall be residents of the district from which they are elected.

Fourth. There shall be seven ex-officio members of the board of directors, namely: The governor of the National Reserve Association, who shall be chairman of the board, two deputy governors of the National Reserve Association, the Secretary of the Treasury, the Secretary of Agriculture, the Secretary of Commerce and Labor, and the Comptroller of the Currency.

No member of any national or State legislative body shall be a director of the National Reserve Association, nor of any of its branches, nor of any local association.

Under the provisions of the plan the New York district, with 29 per cent of the banking resources of the country, would have 8 per cent of the representation on the board; New England, with 12 per cent of the resources, would have 8 per cent of the representation; the Eastern States, as defined in the bill, with 41 per cent of resources, would have 15 per cent of representation; the Middle West, with 24 per cent of resources, would have 31 per cent of representation; the Southern States, with 11 per cent of resources, would have 23 per cent of representation; and the Western and Pacific States, with 12 per cent of resources, would have 23 per cent of representation. The New England, Eastern, and Middle West States, taken together, with 77 per cent of the resources, could elect only 21 out of the 46 directors in the Reserve Association, while the Southern, Western and Pacific States, with 23 per cent of the resources, might have 46 per cent of the representation. These percentages of representation have been based upon the theory that the New England, Eastern and Middle Western States, by reason of their preponderance of capital, would be entitled to elect the maximum number of three directors for each district.

Restrictions on Board Membership

At the first meeting of the board all of its members, except the *ex-officio* members, would be classified into three classes, and the terms of office of these three classes would be respectively, one, two, and three years. Thereafter, members of the board would be elected for a term of three years.

No member of any national or state legislative body would

be a director of the National Reserve Association, nor of any of the branches, nor of any local association.

The directors of the National Reserve Association would annually elect from their number an executive committee and such other committees as the by-laws of the National Reserve Association might provide. The executive committee would consist of nine members, of whom the Governor of the National Reserve Association would be *ex-officio* chairman and the Secretary of the Treasury and the Comptroller of the Currency, *ex-officio* members; but not more than one of the elected members would be chosen from any one district.

The power of the Executive Committee would be limited to the execution of the general policy of action determined by the whole board of directors.

There would be a board of examination elected by the board of directors, from persons outside the banking profession, of which the Secretary of the Treasury would be *ex-officio* chairman.

This selection, it should be clear, places the institution in the hands of men chosen by the several branch offices and of representatives of the Federal Government. The real control, therefore, goes back in the last analysis to the local associations of banks since these are the agencies for choosing the directorates of the branch offices. If the operations of the local associations have been sufficiently safeguarded, the general management of the Reserve Association, as a whole, is adequately protected. For the reasons which were stated in connection with the discussion of these local associations of banks, therefore, it is believed that provision has been made in this tentative plan for keeping the fundamental units in the scheme of federated management—the local association of banks—free of any possible influence originating with selfish or ambitious financiers who might seek to divert bank funds to their own purposes.

The question how the Reserve Association would be managed and directed, is, of course, fundamental. If it were to be managed in such a way as to allow special influence or recognition to certain banks, or groups of banks, the situation would be dangerous. But it is possible to throw safeguards around the enterprise by methods that will not only prevent the development of undue control or influence by large banks and speculative interests, but will largely destroy the influence exerted by such institutions upon the financial system of the country at the present time. As has been seen,

the tendency to centralization of control which exists today among the banks is partly a product of united ownership of stock, either in whole or in part, by the same controlling interests. It is feared by some that under such a system as has been proposed, the National Reserve Association could be dominated by groups of financiers who already have or would acquire large holdings in existing national banks. If, for example, a group of financial interests had a dominating influence in a chain of banks stretching through the various districts into which the country would be divided under the National Reserve Association plan, might not the interests in question bring about a concert of action in their favor throughout the various districts and at the various branch offices of the National Reserve Association? Or if the principal banks of a given city, such as New York, were in large measure controlled by a common financial interest, might not there be a development of practical control over that particular branch office? If such were to be the case, the conditions which already exist in some measure under present methods of banking, would be produced, and perhaps exaggerated. If there were no suitable safeguards upon the methods of voting stock, such a growth of control might reasonably be feared, although it would be far from being the most serious danger to be met.

Management of the Reserve Association Must be Safeguarded

§5. It is fitting that the question how this proposed system would be controlled should be carefully considered. For the reasons already stated, many bankers and borrowers are fearful lest a new system of legislation should throw them still more into the hands of outsiders, who might use their power for selfish ends. In considering the extent to which the proposed new plan would be subject to danger of this kind, it is well to understand clearly what is meant by "controlling" an institution.

What Is Meant by "Control"

The most obvious form of such control would be seen in arrangements that might lead to domination in the choice of directors or other governing factors in the new National Reserve Association. If the new institution were so shaped that certain very limited financial interests might exert an undue influence in the selection of a majority of the directors, the result would be to enable them to dictate to the new institution. They could put their own men in charge of its affairs, and these men would presumably be guided by the welfare of the persons who had placed them in control.

Sectional Control Also a Danger to be Considered

A type of control which might exist, apart from the direct personal influence already sketched, would be seen in the possibility of geographical or sectional control. Directors might be chosen in such a way as to permit them to form groups among themselves, whereby one part of the country would be more powerful than other parts, and would thus be able to direct the policy of the new institution into channels that would forward its own interest as opposed to those of the country as a whole, or of other communities which were competing with those that were most strongly placed in the Board of Directors. More subtle than either of these types of control over the directorate would be a condition, or situation, in which the new institution practically dominated the banks by refusing them discounts or accommodation at its pleasure. If such a condition should be established that certain large banks, even though not very strongly represented in the directorate, were able to get better treatment from the Reserve Association than others, or in any way to influence or direct its policy, the influential character of their position would speedily have its effect in coercing smaller institutions. The smaller banks would see that by deferring to the wishes of the larger institutions they might secure for themselves a friend whose good offices with the National Reserve Association would be very valuable, or who could be used as an intermediary for the purpose of getting rediscounts and doing business which might be rejected, if application were made to the National Reserve Association simply on the merits of the paper as such.

Possibility of Political Control

Apart from these types of control, it is worth while also to mention the possibility of political control due to the development of a considerable body of directors chosen under political influences or amenable to political considerations. All of these types of control over banking institutions may either be observed at the present time in the United States, or are found exemplified in its banking history. The question how far any new institution would be affected by considerations of the same sort is, therefore, a thoroughly practical and reasonable one. The different types of control thus possibly to be exerted may be taken up in their order, beginning with the most elementary form—that of direct intervention in the choice of the personnel of the new institution.

§6. As has been seen at an earlier point, the small banks preponderate in the United States. This is true of every part of the

country. More than 60 per cent of the banks have capitals below $100,000, and more than 90 per cent below $250,000. On the surface, then, the power of electing directors, both to the local association of banks, to the branches of the National Reserve Association, and ultimately to the Reserve Association itself, would undeniably and conspicuously rest in the hands of the smaller institutions. The unit system of voting already described, and the comparatively small number of directors in local associations who would be chosen on a voting basis proportioned to stock ownership in the National Reserve Association, would give a very great preponderance to the small banks. But this condition would hold true only if the small banks were absolutely independent of one another and of the large banks. How far, then, would it be possible for large banks to control the smaller institutions, and through them the National Reserve Association? How far could outside capitalists do the same thing? Assuming that there were no legal restrictions upon the holdings of bank stocks by another bank, so that it was in this respect upon the same footing as a corporation or individual, it is clear that in order to be able to dictate the action of small banks under the system of unit voting already described, it would be necessary for the bank, corporation or capitalist, aiming at such control to obtain a majority of bank votes.

Small Banks Are in the Majority

Let it be supposed that a syndicate should undertake to get control of the N. R. A. It is proper to inquire how easy or difficult the undertaking would be from the point of view of cost alone. It will be readily seen that such control could only be had through the vote of eight of the fifteen branch directories. To secure this it must be necessary to control the majority votes of one more than half of the local associations in each of these eight districts. This could be done either by securing the unit votes of over half the banks in a local association, that is, by controlling a large number of small banks, or by securing the stock vote—amounting to two-fifths the whole—plus enough unit votes to carry fifty-one per cent of the votes cast in electing a branch board. The presumption is that any such syndicate would choose the former course as requiring the less outlay of capital.

Why Control Through Small Banks Is Not to be Feared

At least three solutions of this problem have been attempted, each writer using different conditions and assumptions. The first of these calculations starts with the syndicate as an outside party compelled to buy in at every point. Assuming that the necessary bank

stocks could be had at $200 per share—average book value is a little more than that—the cost would be $856,485,174.

Another calculation supposes a syndicate to be formed among banks already existing and controlling at the outset all banks in all the forty-two cities of 100,000 population. Assuming no expenditure necessary for control of the banks in these 42 cities, it would still be necessary to buy or to organize anew 7,000 banks, properly distributed; and at $25,000 each this could be done by the outlay of $175,000,000. But, of course, the final sum required would be larger than this.

$175,000,000 as an Initial Outlay

A third calculation is based on the distribution of branches as proposed by the bill of the Monetary Commission, as follows:

New England—1	Eastern States—2
South—4	Middle West—4
Far West—4	

Granting the extreme case that the three branches in New England and the Eastern States were already in combination, it would be necessary to secure control of five branches in the South, Middle West, or Far West. From the best information available, it appears that the four branches in the South would involve 4,689 banks with capital and surplus of $372,700,000; four in Middle West, 5,655 banks with capital and surplus of $314,800,000; four in the Far West, 5,334 banks, with a capital and surplus of $314,800,000.

Assuming no opposition from public opinion, the most economical course would be to purchase the four districts of the South and one in the Far West. Supposing the stock of the banks could be had for its book value, the purchase of one-half the southern banks outright would cost $186,000,000; but a controlling interest (51 per cent) could be had for $95,000,000, because it would be necessary to have only 51 per cent of the stock of one-half the banks to be controlled. Add to this the cost of control in one branch from the Far West computed in the same manner and we get a total of $114,790,000.

A Theoretical and Fanciful Calculation

But the book value of Southern banks averages approximately $80,000 per bank. By purchasing one of these and dividing its capital for the purpose of increasing the number of unit votes to be controlled by the syndicate, three new banks could be established with a capital of $25,000 each with a balance of $5,000 to spare. By buying 1,125 banks, 3,580 new ones could be created out of them. When the original number of 4,689 is reduced by the number

bought, 3,580 would constitute a majority and give a controlling voice in the four branches. This operation on the basis of a 51 per cent stock control would cost but $46,000,000. To secure the fifth branch by a similar method in the Far West, where the book value is $60,000, would require the control of only 400 banks and 51 per cent would cost $12,240,000; or a grand total for the five districts of $58,240,000.

Supposing that the old banks could not be bought economically, control might be secured by the institution of new ones with the minimum capital of $25,000 each. To control four branches in the South, 4,690 banks would be required, costing $117,250,000. On the basis of 51 per cent control, the cost would be $59,797,500. Adding the cost of one branch in the Far West computed on the same basis, the entire cost of control would be $76,797,000. This computation is as favorable as it can be made to the possibility of control; although, as will be shown, there could be no motive for acquiring control.

Computation is as Favorable as Possible

Such a computation is wholly theoretical, and takes no account of public opinion, the unwillingness of banks to give up their independence, and the great improbability that directors and local business men would allow the banks to put their borrowers in a position where loans could be dictated by a controlling syndicate. The improbability is so great that this computation—making it as extreme as the case would allow—cannot be taken seriously. Moreover, it assumes that bankers as a class have no honor, no independence, no regard for the business conditions of the country, and are responsive only to the desire for gain; when, in truth, they have the same average qualities as other large classes of the community.

§7. One method of controlling the stock of a large number of banks which has been considered by some of those who are afraid of ambitious financial influence in the National Reserve Association is the formation of a holding company probably in connection with some large national bank. The idea of such a company, it is supposed, would be that of acquiring the stocks of various banks in order to exert a direct influence in their affairs. In those cases where such stocks were owned to the extent of a majority of the shares of the banks to which they relate, the holding company would naturally be able to dictate the policy of the controlled institutions in harmony with that of the larger banks and, of course,

The Idea of Control Through a Holding Company

could dictate the names, or, at all events, the action of the directors themselves. Where there was no majority, but merely a considerable holding, large influence could be exerted. This would be entirely feasible, provided that substantial purchase and holding of stock could be brought about. The fear has a basis since, in some instances, companies of the kind indicated have already been organized and have confessedly put forward as one of their objects the ownership and control of national bank stock.

Present Affiliations of Banks

As already seen, at least 300 national banks have at the present time formed affiliations with trust companies or state banks. In these instances the stock of the national bank is held by the same persons who hold the stock of the state bank or trust company. As the stock of the two institutions thus allied is controlled by an identical body of stockholders, the actions of both will be harmonious. The state institutions can usually be employed, if desired, to purchase bank stocks which are then practically under control of the national bank. But whether the plan pursued be the establishment of a holding company of the kind indicated, or a joint ownership of shares in a state and national institution, uniformity of action and policy is insured. In such cases, it is evident that to the extent of their stock holdings such concerns might be able to exert a more than proportionate influence in the affairs of the National Reserve Association.

The question whether relationships of this kind are legal or not is still under adjudication and an adverse opinion has been rendered by Attorney-General Wickersham. Even supposing that such relationships shall be upheld, however, the difficulties of extending the control to any extent that would make the operation worth while would be impossible for the same reason which has been sketched in speaking of the possibility of direct ownership of the small banks by an individual or concern which might attempt this method of obtaining enough votes to place itself in a commanding position. No holding company could, as a practical matter of fact, acquire enough bank stock to give it a direct majority of votes in the Reserve Association. As for gaining control of one of the branches of the Reserve Association and thereby directing the operations of that particular branch, the undertaking would be more reasonable, but still out of the question, for reasons that will be stated presently. The mere question of obtaining control of the majority of the stock of enough banks to give a majority, either in the directorate of the Association itself, or any one of

Why a Holding Company Scheme of Control is Impracticable.

its branches, would require so great an expenditure that it may fairly be considered impossible, simply as a problem in financial organization and in the acquirement of funds sufficient to obtain the necessary bank stocks by direct purchase. It has, moreover, been suggested that corporations be forbidden to own national bank stock—a plan favored by Deputy Comptroller T. P. Kane. This would render holding company control of national banks impossible.[1]

§8. Discussions of such forms of control are largely academic, although it has been thought well to review them here for the purpose of citing every possibility of domination, no matter how remote. The fact remains that in practice an individual or a concern, even with unlimited capital, will be unable to get a majority of the stock in any such number of institutions as would enable him, or it, to carry out such a plan. Long before a majority of the stock in all of the banks of a small community can be acquired, the operations of one engaged in such a transaction would have at-

A Simple Remedy for Possible Holding Company Control.

[1]Of the possibility of a voting trust or trusteeship Mr. M. S. Wildman says:

Let it be supposed that the stock of the subsidiary banks be individually owned, but placed in trust, with power in the trustee to vote it in determining the policies and directories of the particular banks. There is no well-grounded objection to this, in so far as it concerns the inside working of the banks in question. However, there is serious objection to allowing a bank, whose stock is so held, to exercise full voting-power in the Reserve Association. The law should provide, therefore, that the voting-power of a bank shall be curtailed in the proportion in which its stock may be held in trust, whether the trustee be an individual, a committee or a corporation. Trusteeships for bank stocks are very common and desirable; cases of individual insolvency, the settlement of estates, and the protection of wards, are among the circumstances which give rise to them. The question arises whether any substantial hardship would result from limiting the power of a bank whose stock is so held, in voting for directors of the local association.

The vote cast by a trustee is substantially a vote by proxy. Voting of proxies may not be objectionable in determining the policies of separate banks, but there is precedent for its prohibition when the public interest is supposed to be involved. Of the twenty-five thousand shares of the First Bank of the United States, at one time no less than eighteen thousand were held by others than citizens of this country. According to law, none of these owners of shares could vote, either in person or by proxy, and the control of the institution actually rested with a small minority, holding less than a third of the stock. To this situation no serious objection was raised; and that there was no substantial hardship was proved by the fact that Europeans were anxious to buy the stock at prices far above par. Moreover, the principle of proxy-voting is condemned in the plan now proposed, in the provision that each bank may vote only through its properly-designated officers; and this provision is followed by the words, "There shall be no proxies." No objection has been raised to this restriction. If the prohibition of proxies be no hardship, the restriction of the voting-power of any bank to the extent that its stock is not held by the equitable owner could certainly involve no hardship of practical importance.

tracted the attention of the community. Usually, the attention of the local business public would be riveted upon the operation a long time before such control could be obtained of the shares of even one banking institution. It would be impossible in practice to obtain this kind of stock ownership in very many institutions. Even if it could be obtained by some manipulation or sleight of hand, the fact would remain that the influence thus acquired was largely an empty shell. One who buys a bank under a free banking system gets nothing but the bank's assets; he does not purchase the good will of the banks unless the customers are willing to continue it. Other banks can be organized without difficulty and would be thus organized. The persons who acquired control of the stocks of the different banks would be obliged to pay for them and they would thus provide the old shareholders with the means of reopening competing institutions. Such a bank "trust" as has been described might find itself met at every point by as many new institutions as it got control of. Local communities would not be willing to see their credit entirely in the hands of outside interests any more than they are at the present time. They would transfer their business to other institutions. The only condition under which such a possibility could be seriously considered would be one in which the number of banks in a community or in the country was limited, or in which the organization of the banks was made dependent upon the granting of a special charter. Neither of these conditions can or does exist in the United States today nor is it likely ever to exist. At present, both the Federal Government and all of the states grant bank charters under special laws which allow perfectly free organization of institutions. The National Reserve plan provides that banks organized under state laws shall be allowed to participate in the National Reserve Association upon equal terms with the members of the national system. Nothing is more wildly improbable than that the national and all of the state governments should jointly abolish the free banking system and limit the number of institutions to those which now exist, or even render access to the systems more difficult than it is at the present time.

Good Will of Banks Not Purchasable

Publicity and a Free Banking System Are Safeguards.

Considering, then, the difficulty of acquiring the control of even one institution and the infinitely increased difficulty of obtaining control of all those in a given community or of a large number scattered through different communities, and taking this in conjunction with the fact that the purchase of bank stock would

supply the means for competitive banking, it must fairly be conceded that the fears expressed on this score are entirely chimerical. There is no possibility of the development of any such type of control of the directorates of the different institutions. Neither the unit control of different banks nor the acquirement of sufficient shares by a holding company with or without a national bank affiliation would attain the object sought.

The difficulties in the way of the purchases of such bank stock as are here referred to have been set forth by a banker of international prominence, who has discussed the estimate of cost of control already given above from a critical standpoint. He says that "if one succeeded in acquiring one bank in a city without creating comment, one would be doing well, but to try to do this with more than half of the banks of that city would create such a stir that it could not possibly be done secretly. If, in addition, a bank of the city having a capital of $50,000 should see that sum reduced for no plausible reason whatever—it being presumed that the capital would not have been raised to $50,000 unless the bank required that amount for its standing and its business—and if the only excuse for such action which could be given to the astonished directors would be that it was being done wholesale all over the country, so that the 'ring' might control the situation, it is easy to perceive the indignation that would be aroused and how very welcome a means of advertising would be given to those banks that had remained independent. To acquire a bank against the will of its management and its directors is buying nothing but an empty shell. It is the easiest thing for the directors and the management to take out a new charter and to raise the new capital of $25,000 and to take with them all of the business and all the good will that the old bank commanded. Moreover, the ring would find it a pretty hard proposition to feed 50 per cent of all the banks of a given community and make them valuable. It would be for this reason a very unprofitable investment."

A Banker's View of Such a Possibility.

§9. It is fair to ask whether, even if absolute control of the type described could not be attained, it would not be possible by a judicious acquisition of the stock of influential banks scattered here and there throughout the country to exert a strong general influence in favor of a special "ticket" to be put up for election to the directorate of the National Reserve Association. This suggestion in its more general form must be put aside when it is ob-

served that the country is to be divided into 15 districts, in each of which a separate organization is to be maintained. As many sets of directors as there are districts must be elected. Suppose, however, that a bank limited its operations to the affairs of its own district—how far could it go? It would find in such a case that it must secure the election of directorates under its control in all of the local associations existing throughout the district since these would be the ultimate source from which the directors of the branches (one branch to a district) of the National Reserve Association would be drawn. This would necessitate its scattering its efforts throughout the various local associations in a way that would be found impracticable for the same reasons that would obtain in the case of the institution as a whole.

The Question of Stock Influence.

It may also be asked whether an institution might not secure the control of the directorate of its own local association by obtaining the majority of the stock in enough of the institutions which were members of the Association to enable it to control a majority of the directorate. It should be frankly stated that such a situation would be possible, even if not very probable. It could, however, very readily be met by making the acquirement of stock of no service in electing directors. If it were provided that no institution should vote in elections of the National Reserve Association and its branches to an extent greater than was represented by the independent holders of shares by stockholders the whole difficulty of which so much is now made would be obviated. All possibilities of danger could be overcome by the adoption of a provision in the act allowing a person (or corporation) to select the bank in which he owns shares and wishes his shares to be counted, but reducing the voting power of any other bank in such proportion as the same person owns shares in such other bank.[1] Such a provision would be very drastic, and should be resorted to only as an extreme measure to remove the motive to the acquirement of control over stock

Possible Control of the Local Associations and a Remedy.

[1]The bill of the Monetary Commission contains the following provision: "That in case forty per centum of the capital stock in any subscribing bank is owned directly or indirectly by any other subscribing bank, or in case forty per centum of the capital stock in each of two or more subscribing banks, being members of the same local association, is owned directly or indirectly by the same person, persons, copartnership, voluntary association, trustee, or corporation, then and in either of such cases, neither of such banks shall be entitled to vote separately, as a unit, or upon its stock, except that such banks acting together, as one unit, shall be entitled to one vote, for the election of the board of directors of such local association. In no case shall voting by proxy be allowed. The authorized representative of a bank, as herein provided, shall be its president, vice-president, or cashier."

in a number of institutions, inasmuch as it would debar the holders from obtaining any increase in their voting power at meetings of the National Reserve Association. It would not debar anyone from owning shares in more than one bank for profit, but it would debar such ownership from being used to control the association. There would be no reason for fearing, with such a provision of law, that any particular institution would succeed in exerting an undue power or influence over the operations of a branch of the Reserve Association.

In the last analysis the question would be whether the banks themselves were able to maintain their own autonomy and thereby retain the management of the associations and of the branches of the National Reserve Association in their own hands. It would be easy to require the names of all stockholders in every bank owning shares in the National Reserve Association to be filed with the National Reserve Association head office or possibly with the Comptroller of the Currency. By prohibiting any bank from casting a full vote in elections for directors of the local associations or of the branches, provided any of their stock were controlled by other banks or by stockholders in other banks, it would be practicable to eliminate this kind of joint influence. Inasmuch as, in that case, only those banks would be full voting units whose stock control was dissociated from that of other banks, the exercise of any central influence over the National Reserve Association would be practically precluded and it would be impossible for any individual, or corporation, no matter how much bank stock he or it might buy, to acquire more than a voting power based upon its maximum share ownership in a single institution. The fear of control of the local associations or of the branches of the National Reserve Association would thus be absolutely removed. There would be far less danger of such control than there is today of the joint control of groups of banks. The possibility that the local units would be used in the interest of some financial power would be out of the question.

Possible Control Through Favor and Hope of Profits.

§10. There are other methods than those of stock ownership by which banks are today controlled by other banks. One of these is the distribution of special favors. A large institution, for example, has planned to underwrite certain bonds. It apportions these bonds among a certain number of other institutions, and when the securities are sold and expenses paid the profits are distributed in accordance with the original assignments of securities.

Thus a clear gain accrues to the banks which have originally been designated as recipients of these favors. The knowledge that a large bank has it in its power to distribute profitable opportunities in this way is of course a strong inducement in every case to the small bank to observe the wishes of the larger institution so far as it can. Influence of this kind rarely extends to the country banks, but it is exerted by the institutions of high capitalization situated in financial centers over banks in the same city or in other reserve cities. In return it is of course expected that the banks thus given consideration will exert themselves to serve the interest of the larger bank. If they do so by directing deposits toward it, and otherwise facilitating its operations, the obligation is cancelled. Why might not a similar kind of influence be exerted by such large institutions over other banks in order to induce them to cast their votes in the National Reserve Association for some indicated candidate or candidates who are acceptable to the larger institution?

Small Banks and Public Sentiment as Factors of Safety.

There is under existing conditions nothing to prevent such influence from being exercised nor is there anything in the proposed plan that would do so. Whether such influences would extend very far must, however, be considered seriously open to question. It is highly improbable that many banks could be brought to terms in this way. In every business organization, as in all political or governmental organizations, there will usually be a possibility of irregular work. No system can be devised which will make every citizen upright, and in the same way, no system can be devised that will compel every bank to be disinterested or to maintain its own individuality if it does not so choose. The fact remains that the great majority of banks neither could be thus controlled nor would they allow themselves to fall under influence of this kind. Public opinion would be too strongly against it in those few places where such possibilities were open, and in others, the danger, as already noted, would be practically non-existent. In the aggregate the smaller banks, not subject to such control and voting as units, would be able to direct matters.

But all this would be of no service if there remained conditions that would continue the present system of inter-bank control in full force and would compel the smaller institutions to rely or depend upon the larger. If there were such conditions under the new system, the introduction of elaborately devised machinery would not correct the evils complained of. It would be impossible to control directorates in such a way as to eliminate the chance of undue

influence by large banks if it remained true that rediscounts were to be granted as a matter of favor. In order to abolish the existing tendency toward undue control and to provide an adequate safeguard against the extension or renewal of it under the new system, it is necessary to make such provision as will guarantee the banks against any necessity of depending upon others and will assure them absolute equality of treatment at the hands of the National Reserve Association or its branches when they apply for it. This is what the plan provides for.

§11. While it is an easy matter to prevent the domination of the Reserve Association by any control of capital stock by any institution or group of institutions, the question is frequently asked whether a certain geographical control over a National Reserve Association might not be exerted. Not a few persons have feared that the distribution of capitalization among the banks of the country would be such as to ensure a controlling power to the "east" or to some other section. This, of course, assumes that one section of the country has banking interests that are opposed to those of other sections. Nothing of the kind is true save in so far as there may be speculative centers which afford a greater demand for funds than would come from ordinary commercial sources. It should be borne in mind in this connection that "speculation" is not local or confined to any part of the country. Active real estate speculation exists nearly everywhere. It has been particularly noteworthy in the middle western and western states of late years and has at times imposed a very serious strain on the banks which were called upon to provide the resources with which to carry it on. On the other hand, speculation on the exchanges is not confined to New York or the Eastern states. There is as active speculation on the Chicago Board of Trade as there is on the Eastern stock exchanges.

Geographical Control and Sectional Opposition.

The problem of keeping the funds of the public out of the hands of speculators is one that must be settled by the bankers in their capacity as such, and not by the establishment of governmental machinery for the purpose. But the National Reserve Association would at all events afford no special or peculiar facilities whereby banks in any one section of the country would be able to control or outvote those representing any other section.

Keeping Funds Away From Speculators is a Banking Problem, Not One of Law.

As has been stated, the real operations of the proposed reserve association would be transacted at the branch offices, each of which would work in close conjunction with local associations of

banks. There need be nothing to warrant the belief that such local associations would be influenced by anything except the interests of those who composed them. It would be of far more importance, then, to see that the local associations of banks were kept free of any improper influence than to attempt to safeguard the geographical control of the National Reserve Association. Figures for the capitalization of banks do not warrant the belief that there is any given section of the country which is superior in its banking power to any other. The traditional classification of states as New England, Eastern, Middle, Western, Pacific, etc., shows the following arrangement of bank capitalization for the national system:

No Section Dominant in Banking Power.

		%
New England States	$98,451,950	9
Eastern States	338,508,154	33
Southern States	159,927,430	16
Middle Western States	276,673,100	27
Western States	69,880,100	7
Pacific States	87,290,650	8

For all banks the arrangement is as follows:

New England States	$138,499,518	8
Eastern States	581,370,131	33
Southern States	297,137,727	16
Middle Western States	509,622,221	28
Western States	118,075,127	7
Pacific States	149,279,601	8

Then, if New England, which has 8 per cent of the banking capital of the country, had one branch; the Eastern States, with 33 per cent, had two branches; the Southern States, with 16 per cent, had four branches; the Middle Western States, with 27 per cent, had four branches; and the Western and Pacific States, with 15 per cent, had four branches, certainly the West and South would easily outvote the East—especially the New York district. Even if it be assumed that the states west of the Mississippi have interests of a banking kind different from those east of that line, and that in meetings of the National Reserve Association, or some similar institution where voting power was based on bank capital, there would be a direct voting opposition between them, it is clear that there would still be enough voting power, even in the western states, to make any action that might be deemed obnoxious to the interests of the west practically impossible. The National Reserve Association plan would provide for a strong representation of the government on the controlling board of the organization. This in itself would make possible the turning of any given

decision one way or the other according as the equities of the case might demand. No administration could afford to take obviously inequitable action, distasteful to any large portion of the country since it would speedily be rebuked at the polls and its successor would feel the necessity of rectifying the mistakes that had been made by forcing an undesired policy upon the country. Sectional action would work in the same way to safeguard the National Reserve Association. Finally, it is entirely possible to provide that not more than a given number of directors in the National reserve board shall be drawn from any given area or section.

Unity of Banking Interests

§12. It cannot be too strongly emphasized that there is no such opposition of banking interests as is suggested by the point of view of sectional jealousy or opposition. Every part of the country is interested in the banking success of every other part. A complete identity of interest exists. New York banks and foreign institutions join in furnishing the capital needed to move the cotton crop and they perform the same service so far as necessary in bringing the western cereal and other crops to market and in assisting to finance the movement of manufactured goods generally. There is no ground for supposing that they have any interest opposed to the welfare of bankers in other parts of the country. It is, of course, a constant matter of competition between different groups of bankers to secure as much of the good paper offering in the community as they themselves can carry. They do not care to see this paper, when profitable, taken up by outside institutions. Yet the interests of such banks are entirely identical from the banking standpoint. From the standpoint of profitmaking they are opposed, as are the interests of any competitors. The question of equality of opportunity among such competitors, and not an imaginary conflict of interest between sections of the country, is the real problem to be met in connection with the control of the National Reserve Association. This is the issue which is dealt with in those portions of the plan relating to the organization of local associations. How these associations will be organized and how they would operate in conjunction with the branch offices of the Reserve Association is the real and fundamental problem of the whole question of organization of banking under the new plan.

§13. It is as important to keep the business of banking free from political control as it is from that of ambitious financial in-

fluences which might use the funds of the institution for their own ends. Political control or undue influence in any banking institution implies two distinct evils: (1) the appointment of directors or officers under conditions such as make their tenure of office dependent upon changes in party supremacy and (2) the extensions of loans to persons belonging to or affiliated with the dominant political party and hence likely to exert some influence in the affairs of the government as affecting the bank granting the favors. In some cases this political influence in the making of loans may go so far as to bring about the extension of accommodation for the direct purpose of assuring the retention of given persons in office. Of course it is obvious that neither of these conditions ought to be allowed to exist. The choice of directors in a manner that makes their tenure dependent upon political changes implies a shifting control of the institution which is undesirable from every standpoint. Nothing is more important in the management of any commercial institution than strength and continuity of policy. Neither of these qualities can be expected from persons who are subject to removal or appointment not on the strength of merit but upon that of party affiliation or prejudice. On the other hand, the making of loans in such a way as to placate politicians necessarily means rottenness in banking management and is, if anything, more to be feared than the making of loans in a way that would placate financial interests. The latter are likely to give security for the loans, in which case the thing chiefly to be feared is the diversion of funds from more important to the less desirable objects; while the ordinary type of political loan is likely to be made on inadequate security, the "influence" of the person who seeks the accommodation serving to insure the acceptance of security that would not otherwise be considered as bankable.

Political Control and the Evil It Would Work.

These evils of political control are not imaginary, but were more or less exemplified in the history of the first and second banks of the United States, particularly in that of the second bank. They are likely to appear in any institution which is largely controlled by a board of directors whose majority consists of government appointees. For this reason the National Reserve Association plan seeks to guard against the introduction of a political type of control of the institution by providing for the appointment of four directors only out of 46 in all at the instance of the President. Even these would not be directly named by him inasmuch as they would be the regular officers of the government—the Secretary of the

How Danger of Political Control Is Guarded Against.

Treasury, Comptroller of the Currency, etc. With this small number of representatives standing for the government it could never be feared that they would exert a controlling voice in the management of the affairs of the institution, since they would be so largely outnumbered by the directors chosen in the several districts into which the country would be divided for specified terms of years.

The question may be asked why there should be any political or governmental appointees whatever upon the board of directors. Several reasons exist for giving the government this kind of representation. The proposed institution is to be the holder of the funds of the government and would perform important functions growing out of this holding of funds. There is therefore the same reason why the government should be represented upon the directorate as there is for the representation of any other interest. The Reserve Association is to be a great public institution, not organized primarily for profit, and exerting a powerful influence in the banking system of the country. Thus every reason exists for governmental oversight and examination, and for that more intimate knowledge of policy which could be obtained only by having direct representation in the directorate. This would be attained by the choice of the officials already indicated as members of the board of directors and by the free use of a policy of publicity.

Reasons for Government Representation in the Board of Directors.

Some public men who have recently discussed the question of control of the Reserve Association have taken the view that it ought to be almost entirely managed by directors appointed by the President and subject to confirmation by the Senate. This would be the extreme type of political control tested in the past and found wanting for the reasons already stated. Others have gone to the opposite extreme by complaining of the presence of any representatives of the government upon the board. The proper course lies intermediate between these two radical views. It consists in giving to the representatives of the people a due voice and oversight of the affairs of the institution that they may be conducted with an eye to the general good, while refusing a dominating influence to such governmental officers. This is in order that there may be sufficient continuity of policy, and that the controlling spirits in the organization may be chosen for their success and skill in banking rather than for the possession of those qualities which lead to political success.

§14. What has thus far been said is entirely based upon the assumption that the control of the Reserve Association when ob-

To What Use Could Control of the Reserve Association Be Put?

tained would be of such value as to induce banks to go to the most extreme length in their effort to secure it. It has been assumed that the holding of a position of leadership or authority in the National Reserve Association would be of decided value and significance to the banks that succeeded in acquiring it. Is this the case? Obviously, mere "control" is not wanted for its own sake. Capitalists will not go to the trouble of manipulating votes, much less will they expend large sums of money, in order merely to obtain the prestige involved in the management of a Reserve Association representing the combined banks of the country. If they were willing to undertake the work on a basis of mere public spirit or ambition and without any ulterior object, there might be no harm in allowing them to direct the management of the institution. But of course the supposition of those who are concerned about the control of the Reserve Association is that those who are seeking it are doing so because they want to use the funds for some purpose of their own. This can only be (1) the making of loans upon security of a special type that would be in their possession more largely than in that of other banks, or else (2) the making of loans to them to the exclusion of loans to other persons. If either of these ends could be attained there would be a motive in attempting to acquire control of the Reserve Association. If neither of them could be attained, there would be no reason why any one should wish to obtain such control even though the attainment of it might be a comparatively simple matter.

Speculative Securities Not Recognized as Collateral.

What is feared by most persons who express a dread of ambitious financial control is that the funds of the Reserve Association would be employed for the purpose of making loans on stocks or other speculative securities. The fundamental intention of the Reserve Association is to promote commercial banking. Only in specially guarded cases would the making of loans on collateral be permitted at all. On this point the provisions of the Reserve Association plan would afford full protection by requiring that loans on collateral security could be made only when

> in the opinion of the governor of the National Reserve Association, the public interests should so require, such opinion to be concurred in by the executive committee of the National Reserve Association and to have the definite approval of the Secretary of the Treasury. In such cases the National Reserve Association would be allowed through a branch to discount the direct obligation of a depositing bank, indorsed by its local association, provided that the indorsement of the local association should be fully secured by the pledge and deposit with it

of satisfactory securities, which should be held by the local association for account of the National Reserve Association. In no such case should the amount loaned by the National Reserve Association exceed three-fourths of the actual value of the securities so pledged.

In another way an institution such as has been described would render the idea of central control more than ever remote from facts. At present small local banks, as has been explained, are subject to control by reason of the fact that in times of stress or special demand for funds they have to look to city banks for accommodation. This accommodation is not usually extended in the form of a rediscount in this country. A strong prejudice exists among the banks against making application to another bank for a rediscount. But the same object is attained in other ways. Officers of the small bank secure personal loans from the larger institution and turn them over to their own bank for its use, the nature of the operation being perfectly well understood by the institution which grants the loan. Or the small bank may secure from the larger institution permission to draw on it in excess of its credit. This practice gives rise frequently to large amounts of overdrafts upon which the small institutions pay interest just as they would on a straight loan properly secured. It does not matter whether the extension of accommodation in this way is technically called a "rediscount" or not. The fact that the small institutions have to come to the larger banks for aid remains and is the fundamental consideration. Under the present system by refusing to grant such accommodation the larger institutions can practically direct the policy of the small ones under certain conditions, if they feel so disposed, while by favoring them under other conditions they are able to promote the development of certain kinds of business. This is obviously bad policy. Banks should feel assurance that if they extend accommodation to customers on live commercial paper growing out of legitimate transactions they will be able to dispose of it. They are not able to do so to-day.

How Large Banks Favor Small Ones, and the Result.

The only means of getting relief from this kind of control is found in the establishment of some system which will render it possible for banks to know with great definiteness what they can expect in the way of rediscount and how far they can safely go in extending credit to potential borrowers upon certain classes of security. The advantage of a federation, or coöperative association, of banks of the kind referred to is that under it there would be this possibility of exact knowledge regarding the kind of credit that

could be obtained and the extent to which it could be had. Elsewhere, the methods by which discounts would be granted at the branches of the National Reserve Association have been fully described. At this point it is enough to say that under the proposed plan any subscribing bank would be allowed to apply to its local association for a guaranty of the commercial paper which it desired to rediscount at the branch of the National Reserve Association in its district, while it would be unlikely the officers of an association would refuse a rediscount to any bank when the collateral was beyond question, on the ground that the business of the subscribing bank was not important or for any similar reason. By limiting the total amount of the guarantees which a local association could make to the total aggregate surplus and capital of the banks forming the association, and by requiring that every bank should have on deposit with the National Reserve Association a specified and adequate percentage of the total credit granted to such bank by the association, the danger of over-loans would be met. It would be provided that loans might be granted direct to any shareholding bank in given classes of cases intended to cover all regular and non-speculative commercial operations.

Limitations on Use of Other Securities Than Commercial Paper.

The plan of the Reserve Association in short contemplates that loans shall be made only under conditions that will give all institutions a perfectly equal opportunity. That is to say, the Reserve Association is to be called upon to discount all paper of a particularly described kind, no matter where it may originate or what bank may hold it. Its operations are to be absolutely dispassionate and non-partisan, as nearly automatic as the nature of the case will permit.

All of the privileges and advantages of the National Reserve Association should be equitably and proportionately extended to every subscribing bank. Any such bank may obtain loans from the National Reserve Association in any of the four following ways:

1. *Rediscounts not guaranteed.* The National Reserve Association may through a branch rediscount for and with the endorsement of any depositing bank, such notes as the bank may have discounted for its customers, rediscounted for other banks, or purchased through commercial paper brokers, *the proceeds of which have been used for commercial, industrial, or agricultural purposes, and not for carrying stocks, bonds, or other investment securities.* Such notes and bills should have a maturity of not more than twenty-eight days, and should have been made at least thirty days

prior to the date of rediscount. The amount so rediscounted should in no case exceed the capital of the bank applying for the rediscount. The aggregate of such notes and bills bearing the signature or endorsement of any one person, company, corporation, or firm, rediscounted for any one bank, should at no time exceed ten per cent of the capital and surplus of said bank.

Functions of the Reserve Association

2. *Rediscounts guaranteed.* The National Reserve Association should also rediscount for any depositing bank similar notes and bills of exchange arising out of commercial transactions having more than twenty-eight days to run, but not exceeding four months, provided the paper has been guaranteed by the local association of which the bank asking for the rediscount is a member.

3. *Direct loans to a bank.* Whenever the public interests so require, the National Reserve Association may, with the approval of the governor, the executive committee and the Secretary of the Treasury, discount the direct obligation of a depositing bank, indorsed by its local association, provided that the endorsement of the local association should be fully secured by the pledge and deposit with it of satisfactory securities, which should be held by the local association for the account of the National Reserve Association; but in no such case should the amount loaned by the National Reserve Association exceed three-fourths of the actual value of the securities so pledged.

4. *Acceptances.* The National Reserve Association may, whenever its own condition and the general financial conditions warrant such investment, purchase to a limited amount from a depositing bank acceptances of banks or houses of unquestioned financial responsibility. Such acceptances should arise from commercial transactions and have a maturity not exceeding ninety days, and should be of a character generally known in the market as prime bills. Such acceptances should also bear the endorsement of the depositing bank selling the same, which endorsement should be other than that of the acceptor.

§15. If every bank, entitled by virtue of the fact that it is a stockholder to receive accommodation at the offices of the National Reserve Association, shall be assured of such accommodation, and if every bank shall recognize that its only claim to such accommodation is to be the ownership of specified classes of paper presented for rediscounting, *it will direct its efforts toward the acquirement of this kind of paper rather than toward the control of the Reserve*

Association. That is to say, its objects will be served by complying with the rules which are enjoined upon all those who ought to receive accommodation rather than by attempting to exercise authority of a merely administrative kind. This means, in short, *that the institution is to be placed upon a basis where the directors shall have absolutely no power to favor one bank or to engage in the kinds of business that are feared.*

Control of Other Banks Would Not Interest Bankers

There remains only the question whether it might be worth while to be in control of the Reserve Association in order to make sure that in the event of inability to rediscount beyond a certain sum those who were most influential should be able to get first chance at the accommodations. If it were true that the Reserve Association could rediscount only a very moderate amount of paper such as is the case with many of the larger banks at the present day so that certain applicants for accommodation would necessarily be unsatisfied there might still be a sufficient reason for securing a decisive influence in the management in the institution. There is, however, no basis for any such assumption. Careful restrictions are imposed upon the classes of paper that are to be acceptable at the offices of the Reserve Association; there are provisions for large note issues to be made by the institution; and with the arrangement regarding reserves which permits of their continuous reduction in order to meet necessities (provided that borrowers are willing to pay the additional cost entailed by an increased rate of discount, largely based upon the amount of the lowering of the reserve beyond a specified point), there would be no reason whatever to fear that the Association would ever be unable to comply with all legitimate demands made upon it for the rediscounting of paper.

No Need of Striving for Control to Insure the Gaining of Rights

Experience with clearing-house certificates in the past, as well as the experience of foreign banks, furnishes abundant evidence to show that there is small prospect of exhausting the credit-granting powers of the Association, or of pressing it close to the limit beyond which it cannot safely go in extending accommodation. If, therefore, the operations of the institution were restricted to certain classes of paper, if the discounting of such paper were made invariable so that no favoritism could be allowed to creep in; so that, in short, every bank would be assured of the same treatment as every other; and if, finally, the credit-affording powers of the institution within the limits set for it were practically limitless, the consequence would be that no object whatever could be served by obtaining the

upper hand in its management. Violation of the statutes of the institution would be a heavily-penalized offense and officers would be under the same supervisory authority that is today exerted by the government over the doings of the banking institutions throughout the national system.

Government's Supervisory Powers Over Association Officers

It has been suggested that a motive for trying to gain control over the National Reserve Association might exist in a desire to favor concerns allied with dominant financial interests as against other concerns who were their rivals probably in the same kind of business. Inasmuch as their paper would be commercial, and not secured by stock exchange collateral, here might be a situation in which good commercial paper might be refused by Branch officials at the behest of the great "interests," if they could gain control; thus, even if stock exchange collateral were unavailable, there might be a motive for gaining control.

As to this suggestion there are several points to be considered: (1) The customer retains all his present relations with his bank unchanged. His bank, which wishes his account, retains its present relations with its correspondent bank, from which it can get rediscounts. If a customer is discriminated against, that implies that no bank wishes his account. (2) The real point at issue is, will the National Reserve Association discriminate against any one subscribing bank which presents good commercial paper? Will it be possible to refuse such good paper for the real purpose of driving a rival out of business? This is a difficulty to some minds. The bank, of course, has the alternative of going either to its correspondent bank, as now, or to the Branch of the National Reserve Association. The paper is passed upon by the executive officers of the Branch. These officers are governed by by-laws made by the Directors of the Branch, who are in turn the creatures of the local associations. The action of the branches in rediscounting must, therefore, be amenable to the opinion of the locality. (3) Questions of general policy for the whole country, such as the total magnitude of loans made, reserves to be carried, the uniform rate of discount, and the like must be determined, of course, by the Board at Washington; but the question as to what paper shall be accepted must be determined by the Branch, which is representative if its region. There can obviously be no compulsory discounting ordained by law, any more than good weather can be required by law for the Fourth of July. In the main, reliance must be placed on the character of the management, as in all banking sys-

tems. This character of the management can be obtained by the kind of directors chosen by local associations.

§16. In studying the steps which must be taken in order to remove the conditions that give rise to present-day centralization of control in banking, the conclusion is inevitably reached that the most effective method of avoiding this type of control is that of furnishing an ample and satisfactory market for commercial paper. By this means banks would be assured full consideration of their necessities and could feel confident that they would be supplied as occasion might demand. If assured of a permanent and reliable institution at which to present their paper for rediscount, and with which to redeposit such reserve funds as they did not immediately need, they would cease to feel dependent upon the good will of large city institutions which must be placated in order to insure their aid in an emergency or financial stringency. On the other hand, if banks were supplied with an assured method of obtaining exchange, they would be relieved of the necessity of relying upon a correspondent bank for that service. These and other necessities of similar character could be fully met by the establishment of a strong institution dealing only or primarily with banks, and intended to supply them with an absolutely fair and unbiased agency with which to transact their outside business, from which to get loans, and through which to transfer funds to other banks. They would not, with such an institution at hand, need to trouble themselves about anything except the careful testing of the commercial paper presented to them, in the effort to make sure that the security was safe. All this is based upon the assumption that such an institution, when established, would, as stated, be absolutely independent, free of partisan control, and under no subtle financial influence which would lead it to prefer one bank or group of banks to another.

Safety Through Establishment of an Ample Market for Commercial Paper

§17. The question may arise—if the plan of the National Reserve Association would tend to divert idle funds from the central reserve cities, especially from New York; reduce the amount which can be loaned at call on the stock exchange; direct capital more or less away from speculative loans to the discount markets for legitimate commercial paper; and break up the present feudal dependence of smaller banks upon very large ones: Why do not the large banks in the central reserve cities oppose the plan with all their energy?

Why Large Banks Do Not Oppose Reserve Plan.

No doubt on this question has ever arisen in the minds of any managers of large banks who have passed through crises like those of 1893 and 1907. In an emergency, or crisis, the large banking institution finds itself confronted with exactly the same sort of difficulty, the same restrictions on its power to make new loans, the same inability to provide loans to old customers, as those which confront the small institution; only, it may be said that the difficulties, although of the same kind, are greater, harder to meet, and carry with them larger possibilities of disaster. For instance, a local bank in Missouri, or Kansas, may find itself "loaned up" to its limit, and yet in an emergency additional demands for loans from merchants and farmers are pressing hard. Its duty is to serve the local community; but under the present inelasticity of credit the bank is bound hand and foot. If it fails to use good judgment, or to render aid to legitimate customers, it would cause failures throughout its constituency. Its only help is from its large correspondent bank, probably in St. Louis, Chicago, or New York. So far the facts are clear.

Now, how is it with the large bank having hundreds or thousands of small correspondent banks looking to it for favors, or funds, in time of stress? As these are scattered over a wide territory, the accumulated demands from correspondent banks, when trouble comes, are something tremendous. The failure to respond to aid would, when trouble comes, break down a local bank and carry with it all its customers. The same thing is true of a central reserve city bank. That is, the large bank has exactly the same kind of thing to meet as the small bank, only on a larger scale, with immensely greater responsibilities. If the small bank, therefore, would get relief out of a National Reserve Association, how much more would it be to the interest of the large bank to seek the establishment of such an agency. The common sense of the matter is, of course, that advantages from such a plan would inure to all banks, small or large. In a storm on a rocky coast, when two boats, one small and one large, are using all their seamanship to protect themselves from disaster, a shipwreck of the larger would carry distress to more families throughout the land than that of the smaller ship. The suffering of any one of ten persons on the small boat is, of course, as poignant as that of any one of a thousand on the big boat; but the full extent of the ruin caused by the latter is very much greater. That is, aids to safe navigation—lighthouses, buoys and charts—are quite as much to the interest of

Large Banks Have Trouble in Times of Stress.

the large, as of the small, ship. But suppose that the smaller boat was in tow of the large boat; then, when the larger ship went ashore, in fog or darkness, it would carry the small one with it. Similarly, the system which enables banks to aid their customers with loans in storm and stress is needed even more by the largest than by the smallest banks; and the preservation of a large bank protects the smaller correspondent banks.

Injurious financial control, then, should be made impossible; but preventive measures should be based on a real and expert knowledge of the organization of credit. As it now is we have practical centralization; as it ought to be we would have actual coöperation among all banks in the common interest.

CHAPTER XIV

SMALL BANKS AND THE NATIONAL RESERVE ASSOCIATION

1. Small Banks as Members of National Reserve Association—2. New Duties and Privileges—3. No Rediscount Facilities Under Present System—4. Economies—5. Small Banks to Control National Reserve Association—6. The Chief Danger Now Confronting the Small Bank—7. Many Problems of the Small Bank Would Be Solved—8. Commercial Paper and How It Is Regarded—9. Commercial and Investment Loans—10. Small Banks Will Become Really Independent—11. Divorced From Reserve City Banks.

§1. The National Reserve Association is proposed as a means of completing and perfecting the process of organization of our banking institutions which has been in progress at least since the establishment of our national banking system. It is designed *to serve* these institutions, not *to compete* with them; to add something to what they already have, to increase their usefulness, not to take something away from them or to supplant them. Constituting as they do probably seventy-five per cent of the total number, small banks are vitally concerned in this project.

Small Banks are Vitally Concerned

The plan at present under consideration places before such a bank first of all the alternative of becoming a member of a National Reserve Association or of remaining outside. Assuming that it decides to become a part of the organization, it would be required to subscribe for stock in the Association to the amount of twenty per cent of its capital and to pay half that amount in cash, the other half remaining subject to call. It would also be required to join with the other banks in its vicinity, which had also become members of the Association, in the formation of a local Association. It would not be required to sever any of its existing relations with other banks. It could retain its correspondents, its membership in the clearing house, if it had one, and its bank customers. It could form any new relations of this kind that might be desired. Its relations to the national or the state system to which it belongs would

Membership in the National Reserve Association

not be in any respect disturbed. National banks would continue as at present to be inspected and supervised by the Comptroller of the Currency and his assistants, and state banks and trust companies by the state officers at present entrusted with that duty.

§2. These simple additions to the connections of the small bank would impose upon it new duties and give it privileges not now enjoyed. Chief among the former are the choice of one of its officers as its representative in the election of directors of the local Association and his equipment with any desired instructions, and, in conjunction with fellow members of the Association, the choice of representatives to vote for directors of the district Association and to vote the stock of the Association in the election of directors of the district branch and of the National Association. Another is the assumption, in conjunction with fellow members of the local Association, of the obligation to make good any losses involved in the non-payment by any member, of the paper bearing the endorsement of the local Association, which the bank had rediscounted at any branch or at the central office; the amount of its obligation in such a case being determined by the proportion its capital and surplus bear to the aggregate capital and surplus of all the banks of the local Association. A third is the obligation to report to the National Reserve Association monthly or oftener, if required, the principal items in its balance sheet and to submit to examination by representatives of the local Association.

New Duties and New Privileges

The new privileges to be made available pertain to its reserves, rediscounts and loans, clearings and transfers, note issues and holdings of government bonds. It would be permitted to count as part of its legal reserve its balances in any of the offices of the Association in addition to those with its present reserve agents which it is now permitted to count. This would relieve the small bank of the obligation now imposed of keeping locked up in its vaults cash to the amount of at least six per cent of its deposits. It would also be relieved of the necessity of keeping reserves against time deposits payable more than thirty days ahead.

Reserves Not Locked Up

§3. In the matter of rediscounts small banks at the present time have very limited, if any, facilities. Occasionally as a special favor their correspondents will take some of their customers' paper, but ordinarily they are obliged to hold such paper until maturity and frequently to renew it. The plan for a National Reserve Asso-

No Rediscount Facilities Under Present System

ciation proposes materially to change this condition of affairs by furnishing adequate rediscount facilities. Genuine commercial bills maturing in not more than twenty-eight days, which have been made at least thirty days previously, are to be rediscountable *directly;* that is, when presented by the bank itself without the mediation of its local Association. Bills of the same character maturing in not to exceed four months are to be acceptable for rediscount when endorsed by the local Association. In cases of special need loans are also to be made directly to banks on the security of their own paper endorsed by the local Association and secured by collateral. Such loans, however, must have the approval of the Secretary of the Treasury, and are intended to meet special exigencies only and would not probably, therefore, be often available for small banks.

Indirect as Well as Direct Benefits From Membership in Reserve Association

It should be noted that the extension of these rediscount and loan facilities to all banks will benefit the small ones not only directly but also indirectly by making it possible for their large correspondents to grant them facilities in this line not now possible. Being able themselves to secure ample accommodations from the Reserve Association, these correspondents will be able without danger to rediscount for their small-bank customers and to loan to them. The latter would thus doubtless be able to rediscount other paper than that acceptable to the Reserve Association and would be able to avoid application to the local Association, if for any reason that should not seem desirable. Small banks which do not belong to the Association would in this way also be able to enjoy some of its advantages.

Economies and Avoidance of Charge for Shipping Currency

§4. Another very valuable privilege is that of the transfer without charge of the whole or any part of a bank's balance with the Reserve Association to any other bank having an account with the Association. This would practically eliminate exchange charges and greatly diminish the time now required for the making of exchanges between distant places. Another saving would be effected by the privilege of securing without cost shipments of the circulating notes of the Association. Since these would serve all the purposes of cash and could be counted as a part of the legal reserve, banks would be saved the greater part of the expense now involved in currency shipments to replenish depleted supplies.

Another feature of the plan of great importance to small banks

is the privilege to be accorded local Associations of exercising the powers and functions of clearing houses. If these Associations should generally avail themselves of this privilege, the collections of the small banks would be greatly facilitated and the greater part of the expense now involved in them eliminated. Since these local Associations would embrace the entire country and would be connected with each other through the branches and the central office of the general Association, banks would have no difficulty in disposing at par of any check or draft, no matter in what part of the country drawn or payable. Since clearing balances would be made payable in checks against balances in the Reserve Association's offices, no shipment of currency would be required in their settlement. This privilege would remove one of the chief causes of friction now existing between small banks and their correspondents, a considerable amount of irritation now being caused by the refusal of the latter from time to time to accept certain checks or to collect them without a heavy charge for exchange.

All the privileges thus far described would be available to state and national banks alike. The latter would enjoy the additional one of being able, if they so desire, to dispose of their government bonds at par without forfeiting their national charters. The plan does not contemplate the application to national banks of any pressure to give up their present issues, but it offers them the opportunity on terms that are fair and that involve little, if any, loss. The extension of their note issues beyond the amount outstanding at the date of the organization of the Association is not to be permitted.

The plan further proposes to permit national banks to lend a portion of their savings deposits on real estate security, thus removing one of the handicaps under which they now operate in competition with state institutions. This privilege concerns principally the small banks of this group, especially those located in small towns and country districts. It would greatly enlarge their capacity to serve their present constituents and to add to their number.

National Banks Could Make Loans on Real Estate Security

Another privilege is offered national banks by this plan, namely, that of accepting bills for their customers. This concerns small institutions as well as large, although the latter will doubtless make most use of it, at any rate at first. To the small bank, however, it offers a form of two-name paper which in many cases it will be able to substitute for the one-name paper it is now obliged to accept.

§5. The assumption of the obligations and the enjoyment of the privileges which have been mentioned are calculated to strengthen the small banks of the country, improve their business methods and remove from them the chief obstacles in the way of their proper development and the chief dangers which now threaten them. In substantiation of this claim it should be noted first of all that the plan now under consideration proposes to put the control of the National Reserve Association in their hands on the assumption that an institution which is designed for the service of banks ought to be controlled and managed by them; otherwise there is danger of its becoming a master instead of a servant. The assumption of such an obligation is a great responsibility, and like all great responsibilities it promises the development of strength as well as power.

Small Banks to Control National Reserve Association

One of the penalties which our small banks have been obliged to pay for their independence of ownership, their close connection with local interests and their circumscribed field of operations is relative isolation. They are at a distance from the larger currents of affairs and in ordinary times out of touch with them. As a rule only when crises threaten or actually occur does the fact that they are but parts of a great mechanism of exchange, international in the scope of its operation and influence, strike their attention and impress them in a vivid manner. Among the consequences of this isolation are inaccessibility to sources of information essential to the proper training of their officers and to the safest and most successful conduct of their business, and a species of provincialism which stands in the way of progress.

A National Reserve Association controlled by them would bring small banks into close touch with each other, with larger banks in the commercial centers, and with itself, the balance wheel of the entire system. As members of a local Association and financially responsible for losses resulting from defaulted paper rediscounted by fellow members, they would be forced to interest themselves in each other's affairs and in the economic activities of the region embraced in the Association. Having the duty to vote for directors of the branches and of the central Association at Washington and being vitally interested in the discount, reserve and issue policies practiced by them, they would be obliged to study these matters, and through them the financial and commercial facts and movements on which they are based. No bank could properly per-

Responsibility Would Make Them More Careful and More Widely Interested

form its function in the proposed organization without strengthening its officers and directors along lines which tend to develop length and breadth of vision, broad-mindedness, wider and deeper knowledge of banking and commercial affairs, and the spirit of coöperation and patriotism.

§6. Among the more obvious services a National Reserve Association will render the small banks, are the removal of the chief danger which now menaces them, the increase of their capacity to serve their constituents, and the power it will place in their hands for the inducement of the coöperation of their constituents in the development of sounder business methods.

The Chief Danger Now Confronting the Small Bank

The chief danger which now menaces the small bank which honestly and faithfully serves its constituents is the locking up of its resources in unmarketable securities. Its chief business is the receipt of deposits which it agrees to pay on demand and their loan for considerable periods of time on personal security, usually one-name paper. Its borrowers consist chiefly of local business men who are little known outside of their home town and whose paper in consequence is unmarketable except at the local bank. The quality of this paper varies widely, but, all things considered, is high. It is not revealed by the face of the instrument itself, however; can be tested as a rule only by the banker of the man who makes it; and his method of putting it to a test would frequently not pass muster in a court of credit men. In fact it is the essential conservatism and soundness of the methods of the average American business man upon which dependence is placed rather than upon balance sheets, careful investigation, or collateral.

Its Relation to Its Constituents Personal and Private

Moreover, the small banker's relation to his constituents is personal and private. In this respect it resembles that of a physician to his patient. The business man expects his banker to afford him such accommodations as he needs in the form of loans, and the banker is obliged practically to assume this obligation. His cash resources, however, which are even further beyond his power of regulation and control, bear no necessary relation to the magnitude of these loans. They depend primarily upon the amount of money in circulation in the community, the number of his depositors who are not borrowers and the relative proportion of time to demand deposits. If it were not for the fact that most of his borrowers receive the proceeds of their loans in the form of balances against which they check, and his ability consequently to pay off one cus-

tomer by borrowing from another, he could not do business at all. But in spite of the high development of the check system in this country, the danger of being called upon for more cash than he receives from his customers in the normal course of events constantly menaces him. At the present time he is able to provide against this only in a very imperfect and haphazard manner. There is no regular and normal way of so doing. He must always resort to such expedients as his ingenuity and conditions at the time suggest.

§7. The National Reserve Association will completely change all this. It will provide an easy, normal and always available method of adjusting cash resources to needs, and that, too, without compelling the small banker to change in any essential particular his present business methods or without in any way curtailing his activities. In case he is threatened by a shortage of cash, he will simply need to select those notes from his portfolio which mature in the near future and which he knows from experience or from prearrangement with the customers whose names are upon them, will be paid at maturity instead of renewed, and turn them over to the nearest branch of the National Reserve Association for rediscount. A favorable credit balance will thus be created against which he can draw to the extent of his need. Upon demand the Association will even ship him currency free of charge.

National Reserve Association Would Solve Many Problems of the Small Bank

This privilege of rediscount will not only relieve the small banker of his chief anxiety and his chief danger, but will enlarge his capacity to serve his constituents. Safety now compels him either to keep on hand funds in excess of his real needs and in excess of the legal reserve, which he is forbidden to use, or else to invest in such securities as he can readily turn into cash, and these are rarely the kind that his customers can supply. In either case his constituents are deprived of the use of funds which the National Reserve Association will enable him to place at their disposal.

Furthermore, the National Reserve Association will enable the small banker to place at the disposal of his customers foreign capital to a degree which is now impossible. He will not be obliged to reject a good loan simply because he is "loaned up." He can always turn such a loan over to the Reserve Association, provided only the proceeds are to be used for strictly commercial purposes. This limitation will prevent him from lending assistance to such of his customers as are interested in over-expansion and inflation, but in no way interfere with his aiding them in the prosecution of legitimate commerce.

Outside Capital Will be Made Available

The fear has been expressed that danger lurks in the scheme at this point, that the National Reserve Association will make it so easy for the small banker to get capital for his customers that they will be encouraged to embark in all kinds of inflation schemes. This fear is based upon a misconception of the nature of the commercial paper to which it is proposed to limit the investments of the Association, and upon a failure to note the effects of variations in the rate of discount.

§8. The term "commercial paper" is commonly used in this country to mean paper that is sold about the country by brokers, and small bankers, having frequently suffered loss from investments in it, do not rank it highly. Indeed many of them will have nothing to do with it. Emphasis should be placed on the fact that as the term is used in connection with the National Reserve Association it means something very different, namely, paper which represents movements of goods from producers to consumers, the transformation of raw materials into finished products, of the seed, fertilizers, machinery, labor and tools of the farmer into crops, and of lean into fat cattle, etc., etc. It should be contrasted with *investment paper,* which represents the capitalization of new enterprises and the enlargement of old ones, the purchase of land, water powers, irrigation projects, the construction of buildings, the opening up of mines, and the building of railroads, lighting and heating plants, etc. Commercial paper in this sense is to be found in every community. It is presented to the banker by his own customers and is more abundant than any other form of loan.

The Term "Commercial Paper" and How It Regarded Is Usually

Inflation results when investment loans exceed current savings, because when this happens, banks assume demand obligations, that is, issue currency against obligations which will not be paid for years, and the currency consequently piles up, accumulates, instead of being returned and redeemed. When, however, they invest in commercial paper, they simply act as intermediaries in an exchange of goods against goods, the currency which they create being returned to them for cancellation by the completion of the processes of exchange in which it originates, and this normally happens, sometimes in a few hours, usually in a few days or weeks, and at the longest in a few months.

Against the possibility of even temporary inflation caused by over-investment in commercial paper of the longest maturities or by a temporary stoppage of the ordinary processes of commerce, the

power of the Reserve Association to regulate the rate of discount is a safeguard. When that rate is raised, it will check the rapidity of exchange operations all along the line and diminish their magnitude. When it is lowered the opposite will happen. The Reserve Association will thus be able to maintain a proper adjustment between the country's commerce and its credit operations.

Safeguard Against Inflation

§9. The emphasis which the Reserve Association will be forced to place on commercial paper and the fact that it will supply for the first time in this country an open market for such paper will tend to influence in a wholesome fashion the business habits of small banks and their constituents. Few of these now observe in their practice, and perhaps many of them are unconscious of, the distinction which has just been drawn between commercial and investment loans. In consequence they contribute, without doubt unconsciously in most cases, to the inflation of credit which characterizes every period of prosperity. The National Reserve Association will force this distinction upon their attention and will furnish them a strong motive for its observance in practice. Unless our experience proves to be different from that of other countries, once a market for commercial paper is created, it will be placed at the top of the list of bank investments, and the rate on it will be the lowest in the market. Small bankers will, therefore, be able to offer customers decidedly better terms for paper of this kind than for any other, thus furnishing them the strongest kind of a motive for giving this character to as large a proportion of their obligations as possible.

Commercial and Investment Loans

This will also materially aid such bankers in the very difficult task of inducing their customers to disclose the uses to which they propose to put borrowed funds and to supply financial statements of their business operations. At the present time small bankers are able to get this information only to a limited extent, especially in regard to paper furnished by note-brokers. When they are able to offer a customer a one or two per cent reduction in the rate of interest on all paper which bears on its face or in the form of attached documents the evidence of its commercial character, he will no longer hesitate to furnish what is wanted. If he does, he will force his banker to the conclusion that he cannot furnish it and thus injure his own credit.

It is at this point that the significance of the proposal to allow

When Acceptances Will be Superior to Promissory Notes

banks to accept drafts for their customers appears. Such acceptances will be useful and superior to promissory notes only in the financing of purchases of goods at distant points, the buyer in such cases being able to discount a bank acceptance, but not that of an unknown merchant. The name and location of the drawer will in most cases reveal to the accepting bank the nature of the transaction on which the bill is based, and the customer will derive the advantage of getting credit for the period in question at a lower rate than would otherwise be possible.

§10. Not so obvious, perhaps, but quite as important in the long run are the scrutiny and supervision of his fellow bankers and the increase in real independence which the National Reserve Association will bring to the small banker. In order that the officers of the local Associations may be in a position to pass intelligently upon the quality of the paper submitted to them for rediscount, they must carefully study the business methods of the bankers with whom they deal, and this study will not be spasmodic but continuous. Their fund of knowledge will constantly increase and become the common property of the entire banking community. Every bank will have a pecuniary interest in keeping its fellows up to a high grade of soundness and will be obliged to conduct its own affairs in the open. The knowledge of this fact and the consciousness of this scrutiny will be the most efficient check on bad banking yet devised in this country. It will do for small banks everywhere what clearing-house inspection in some of our large cities has done for banks thus associated.

Small Bank Will Become Really Independent

This mutual scrutiny and supervision will furnish the best possible guarantee to depositors. Deposits can never be in danger so long as loans are properly made and safeguarded and are readily transmutable into cash, and it is primarily on loans that this scrutiny will be concentrated. The borrowers of a bank will gradually be revealed by the paper sent up for rediscount and their character will be put to the test of outside, disinterested investigation. In this investigation the banker will ultimately find his strongest weapon against the undue pressure of unscrupulous and plunging borrowers.

Best Guarantee to Depositors

§11. It is a widespread belief at the present time that the much boasted independence of the small American bank has been partially, if not wholly, lost. Without attempting to examine the

validity of the grounds usually assigned for this belief, it is pertinent to note the fact that a degree of dependence upon reserve city banks and the stock market is unavoidable under present conditions. The small banker must have liquid assets and his only method of getting them now is by the favor of his reserve agent in granting him rediscounts, or loans on collateral, or by investments in stock exchange securities. Whichever horn of the dilemma he chooses, he delivers his fortunes in part into the hands of other people. His reserve agent is not obliged to rediscount for him or to grant him loans. Neither obligation is necessarily involved in the reserve agent function. The small banker must ask these privileges as a favor and in consequence must be prepared to grant favors in return, and these return favors at times may seriously interfere with his independence. When he invests in stock exchange securities with the expectation of turning these into cash in case of need, he throws his fortunes to that extent into the hands of the people who have most influence in the marketing of such securities, and, in order to be on the right side of the market, he is tempted to seek their favor and to follow their advice.

National Reserve Association Will Deliver the Small Banker From Thralldom

The National Reserve Association will deliver him from both kinds of thralldom. It will give him an institution of his own in which he has property rights and over which he has control, to which he can always turn for cash as a right instead of a favor, which in fact exists primarily for the purpose of rendering him this service. He will then be truly independent, an equal among equals, the arbiter of his own fortunes.

§ 12. Recently the fear has been expressed that some small banks would be unable to derive much benefit from rediscounts through the proposed Reserve Association because the greater part of the paper they hold is of longer maturities than four months, the maximum the Association is to be allowed to accept. This fear is based upon a misconception of the clause in the proposed act which permits rediscounts of paper maturing in not less than twenty-eight days. Such paper must have been in the possession of the bank for at least thirty days, but it *may have been there for a much longer period.* Every bank always has on hand paper maturing during the coming month. So far as this regulation is concerned it matters not how long it may have been in the bank's possession. Provided it is actually payable within twenty-eight days it falls within the category of directly rediscountable paper.

Small Banks' Rediscount Privileges Ample

It should furthermore be remembered that nothing in the proposed plan prevents correspondents from rediscounting for their bank customers paper of longer maturities than four months, and their ability to rediscount with the Reserve Association will give them facilities for so doing which they do not now possess and a motive for so doing which does not now exist. Such banks will ordinarily have plenty of paper which falls within the rediscountable categories and, in order to prevent the removal of their bank customers' balances to the Reserve Association, they will find it in their interest to accommodate them in every possible way.

CHAPTER XV

STATE BANKS AND TRUST COMPANIES

1. A Large Number of State Banks and Trust Companies—2. The Problem of State Banks—3. Control of State and National Banks by Each Other—4. Reserve Plan Puts State and National Banks on Same Footing—5. Trust Companies and Mutual Savings Banks—6. Uniformity of Examination—7. A Single Discount Market—8. Benefit of a Reserve Association to Institutions Outside It.

§1. The national banking system is merely the core of the present system of banking in the United States. The national institutions number over 7,300, while beside them there exist institutions organized under state laws to the number of at least 17,000 or 18,000. Some of the state banks have small capital; others large capital and resources. Some of the strongest banks in the country are private partnerships organized under state laws and engaged in foreign trade and operations for which other banks have no facilities.

Large Number of State Banks and Trust Companies

Congress has paid little attention to these various classes of institutions, except that in 1866 it taxed the notes of state banks at the rate of 10 per cent so as to make the further issue and circulation of such notes impracticable. It was then desired to reserve the function of note-issue entirely to national banks, but beyond this early and exceptional action, the federal government has not sought to interfere with the activities of the state institutions.

While it is true that there is great variation in the laws of the several states, it is also true that in the main the banking systems of the states have been copied from the national banking system. The trust company laws of the several states have been a later evolution designed to permit the growth of a class of institutions equipped to do special kinds of business allied to banking. These trust companies originally engaged chiefly in the operations which their name implies; then having large funds of their own,

State Banking Laws Modeled After the National System

where not prevented by law, they understook to do their own banking, and rapidly developed into concerns possessing large banking departments receiving funds and making loans in very much the same way as regular banks. While many of them are strong, highly-organized institutions with large reserves, they have in general been disposed to do a much broader type of business than the banks, to accept much less convertible security, and to be much less stringently managed in respect to the maintenance of reserves and the liquidity of assets. But, in the aggregate, both the trust companies and the state banks are performing a very substantial share of the regular banking business of the country—so much in fact that their welfare has a direct and immediate relationship to that of the national banks. Their position, therefore, in relation to any new legislation is fundamental.

Development of Trust Companies

§2. The essential problems which have come to the front with respect to the relations of state and national banks may be summarized as follows: (1) The equalization of conditions of business and competition between state and national institutions; (2) the equalization of methods of banking and government oversight between the two classes of banks; (3) the harmonizing of the interests of the two groups of banks so as to strengthen and unify the discount market of the country for the future. New legislation, whatever it may be, must consider these three important phases of the situation. If such legislation should relate only to national banks, it might operate to give these institutions a decided advantage over their competitors.

The Problem of State Banks

In this connection must also be borne in mind the fact that by a process of joint ownership and stock control a very close relationship has been established between state and national banks in many cases and that this inter-relationship must be so regulated by law as to prevent the use of state laws by national institutions for the purpose of controlling others and vice versa. This raises the question whether so close a relationship should be permitted to continue, and if not what substitute can be found for it or how the difficulty which it was intended to remedy can be overcome.

Close Relations of State and National Banks

It is generally conceded that the continued maintenance of banks in a different position before the law, controlled in decidedly different ways, and subject to entirely different requirements, must necessarily cause serious interference with the har-

monious and uniform organization of any system of general banking control. In brief, the question presented is: What shall be the future relations between national banks and institutions organized under state laws, in order to promote the best interests of both?

Further explanation of the difficulties which arise out of differences in competitive conditions shows that the national banks are subjected to very decided restrictions with reference to the classes of business they can do. For example, they may not lend more than an amount equal to 10 per cent of their capitalization to any individual or corporation, capitalization being interpreted to mean capitalization plus surplus when the latter does not exceed 30 per cent of nominal capital. They may not incur obligations of certain specified kinds or make loans on security of given classes such as real estate. Moreover, they are obliged to submit to examination at times and under conditions which are quite different from those that govern in the case of the state banks.

Restrictions on National Banks

The trust companies are in a particularly favored condition. In many states they are subject to negligible reserve requirements, whereas the national banks, as we have elsewhere noted, are very closely bound down in the matter of reserves. The same thing is true with reference to the classes of operations in which they can engage.

Advantages Enjoyed by Trust Companies

A great deal of business offered to a national bank in the ordinary course of events must be refused. When thus refused, it naturally goes to some other institution, frequently a rival bank organized under state laws or to a trust company which is affiliated with a state bank. The national bank is thus sending business to its rivals. It is not only debarred from earning the profits which might be obtained from the rejected business, but it also loses the valuable financial connections which might be established through the acceptance of this business. On many accounts, therefore, it finds the sacrifice of the operations which are closed to it under the national banking law a great source of weakness. Although in the main the restrictions of the bank act are wise, when taken in the aggregate as they apply to the banks as a complete group, it remains true that there are many instances in which they work a decided hardship and in which, therefore, the bank affected by them is naturally restive under these restraints.

Urged on by the pressure of competition offered by state institutions not subject to restrictions as stringent as those of the

national act, many national banks have devoted themselves to devising ways of competing successfully with the state institutions, while at the same time technically observing the requirements of the national bank act. The method most favored in that connection has been the organization of institutions under state law, closely affiliated with the national banks themselves and at the same time able to do all those classes of business which are within the reach of the state institutions, although beyond the scope of the national bank's powers.

Ways of Evading the Law

This system of organizing affiliated state institutions has been greatly developed. It discloses many elements of danger. Investigations made by the Comptroller of the Currency at the request of the Secretary of the Treasury have shown that in not less than 300 cases national banks are thus affiliated with state institutions—either banks or trust companies. Sometimes they are united by the common ownership of stock by bodies of stockholders practically identical for the two institutions, and sometimes by an arrangement wherein the stock of each institution is made non-transferable except upon condition that the stock of the other is simultaneously transferred along with it, share for share.

Elements of Danger in Affiliation of National and State Banks

The dangers inhering in this relationship have been seen partly in the possibility of the establishment of an inter-bank control which might conceivably become dangerous. Particularly would this danger exist from certain standpoints in the event that a Reserve Association were to be organized whose stock should be owned by the banks of the country, in proportion to their own capital stock. Under existing law, national banks are forbidden to own the stock of other banks, for although the law does not contain any such prohibition in express terms, the Supreme Court has decided that this is its intent. But by close affiliation with a state institution in the way just referred to, it is entirely possible for the national bank to reach the same end as if it actually owned or controlled the stock of other banks.

Through the intermediation of the trust company or state bank, the national bank can frequently hold and direct the use of such stock in other institutions. It is true that there are states which forbid this kind of control by prohibiting banks organized under their laws from owning the stock of other banks. This prohibition is found in a number of states. But there are many others where it does not exist.

Even if the question of control be left out of account, it remains a fact that the association of a national and state institution in the way referred to is likely to be always a matter of criticism. It evidently gives to the bank which is organized under the more stringent set of laws a means of taking advantage of the laws of the less stringent jurisdiction. This raises in a serious way the question how to rectify the relationships between national and state banks, and bring them to a proper basis.

Control of State and National Banks by Each Other

§ 3. So strongly have the national authorities felt on this subject of bank control that President Taft and Secretary McVeagh in recent communications to Congress have demanded legislation prohibiting national banks from directly or indirectly controlling the stock of other banks. Legal difficulties have been raised in connection with the adoption of such legislation. But in spite of these difficulties the fact remains that the spirit of the enactment is the most important matter and that a plain prohibition incorporated into existing law would go a long way in correcting the conditions complained of.

The National Monetary Commission in the banking plan lately presented by it to Congress has recognized the necessity of guarding against the possibility of such control as has been referred to and has therefore incorporated in its proposed bill the following provision:

Prohibitory Provision in Monetary Commission's Bill

> **That in case forty per centum of the capital stock in any subscribing bank is owned directly or indirectly by any other subscribing bank, or in case forty per centum of the capital stock in each of two or more subscribing banks, being members of the same local association, is owned directly or indirectly by the same person, persons, co-partnership, voluntary association, trustee, or corporation, then and in either of such cases, neither of such banks shall be entitled to vote separately, as a unit, or upon its stock, except that such banks acting together, as one unit, shall be entitled to one vote, for the election of the board of directors of such local association. In no case shall voting by proxy be allowed. The authorized representative of a bank, as herein provided, shall be its president, vice-president, or cashier.**

There may be difference of opinion as to the question whether this provision is sufficiently stringent or not, but it is clear that the amount of stock which could be permitted to be controlled by another bank may be decreased to any extent that is desired. The extreme penalty available to the government is simply the loss of voting power in the National Reserve Association, and for any

further legislation designed to prevent the junction of banks in this way it would be necessary to go to the state legislature. The adoption of a provision like that just referred to would, however, entirely prevent the possibility of action by any one bank designed to increase its influence in the National Reserve Association or any similar institution whose stock was held by banks, through the ownership of stock in other banks that enjoyed the privilege of voting in such a concern.

Probably a more important means of checking the growing tendency toward joint control of national and state banks is seen in the effort to place these institutions upon a basis of equality, in respect to the business they can do. We have already noted that one important reason why national banks have sought to affiliate themselves in this way with the state banks is that the latter usually have broader powers, while trust companies organized under state laws almost invariably have. If the national banks had the same kind of powers that are possessed by state banks and trust companies, they would not seek to establish this sort of inter-bank control.

Equality as to Business of Banks

The plan of a reserve association proposed by the National Monetary Commission gives to national banks the power of lending a certain portion of their resources upon real estate security, enables them to do a savings business upon more satisfactory terms than at present, and broadens their authority in other directions. With these concessions made to the competitive demands of business, it is likely that the national banks would be largely relieved of any necessity or strong desire for establishing close affiliations with state institutions. In fact, some of those who have made a close comparison of national and state banks from the standpoint of actual business competition are disposed to think that the national banks would have the advantage of the state organized concerns, in which case there would be no motive for affiliation.

Enlarged Powers of National Banks

In speaking on this point before the American Bankers' Association at the 1911 meeting in New Orleans, President F. H. Goff of the Cleveland Trust Company, of Cleveland, Ohio, expressed the opinion that state banks would be at a disadvantage in a number of respects under the proposed plan. These he enumerates as follows:

Objections in Behalf of State Banks

(1) State banks could not accept paper drawn on themselves.

(2) In many states they could not establish branches.

(3) They could not own stock in banks doing business in foreign countries.

(4) In most jurisdictions they would be compelled to maintain greater reserves against their demand deposits than is required by the law of the state where they are located.

(5) While national banks would not be required to keep any reserve for time deposits not payable within 30 days, state banks in most jurisdictions would be compelled to do so.

(6) While national banks would be required to keep a reserve for savings deposits equal to only 40 per cent of that required for demand deposits, which in reserve cities would be ten per cent and in non-reserve cities 6 per cent, state banks in many cities would be compelled to maintain a 15 per cent reserve against savings liabilities.

(7) Funds deposited with the Reserve Association could not be counted as reserve.

(8) Notes of the Reserve Association held by state banks could not be counted as reserve.

(9) State banks must agree to submit to such examinations and to make such reports as may be required by federal law or by the local association.

§ 4. These supposed difficulties grow out of the fact that the National Monetary Commission plan calls for the establishment of uniform reserve requirements in connection with state banks which become members of the National Reserve Association. Such requirement would, it is supposed, subject the state banks to the onerous features of the new legislation, while they would not be relieved, as the national banks would be, of those onerous features of existing legislation which were no longer necessary because of the organization of the National Reserve Association. The requirements of the National Monetary Commission's plan on this subject have met with general approval and are as follows:

Reserve Plan in Regard to State Banks

The subscriptions of a bank or trust company incorporated under the laws of any state or of the District of Columbia to the capital stock of the National Reserve Association shall be made subject to the following conditions:

First. That (a) if a bank, it shall have a paid-in and unimpaired capital of not less than that required for a national bank in the same locality; and that (b) if a trust company, it shall have an unimpaired surplus of not less than twenty per centum of its capital, and if located in a place having a population of six thousand inhabitants or less shall have a paid-in and unimpaired capital of not less than fifty thousand dollars; if located in a city having a population of more than six thousand inhabitants and not more than fifty thousand inhabitants shall have a paid-in and

unimpaired capital of not less than one hundred thousand dollars; if located in a city having a population of more than fifty thousand inhabitants and not more than two hundred thousand inhabitants shall have a paid-in and unimpaired capital of not less than two hundred thousand dollars; if located in a city having a population of more than two hundred thousand inhabitants and not more than three hundred thousand inhabitants shall have a paid-in and unimpaired capital of not less than three hundred thousand dollars; if located in a city having a population of more than three hundred thousand inhabitants and not more than four hundred thousand inhabitants shall have a paid-in and unimpaired capital of not less than four hundred thousand dollars; and if located in a city having a population of more than four hundred thousand inhabitants shall have a paid-in and unimpaired capital of not less than five hundred thousand dollars.

Second. That it shall have and agree to maintain against its demand deposits a reserve of like character and proportion to that required by law of a national bank in the same locality; provided, however, that deposits which it may have with any subscribing national bank, state bank, or trust company in a city designated in the national banking laws as a reserve city or a central reserve city shall count as reserve in like manner and to the same extent as similar deposits of a national bank with national banks in such cities.

Third. That it shall have and agree to maintain against other classes of deposits the percentages of reserve required by this act.

Fourth. That it shall agree to submit to such examinations and to make such reports as are required by law and to comply with the requirements and conditions imposed by this act and regulations made in conformity therewith.

While it may be conceded that under this condition of affairs the state banks would be at a relative disadvantage, it is not likely they would long continue in that condition. Mr. Goff, whom we have already quoted, says: "While the disadvantages at the outset would be many and burdensome, I am confident the legislatures in the several states can be relied upon to promptly enact legislation correcting these inequalities." There is no doubt that this opinion is well founded.

Plan Would Unify Banks

In fact, it is one of the best features of the National Reserve plan that it would tend to unify the state and national banking systems. With a definite pattern afforded by federal legislation, with which the state banks were willing to comply in order that they might be placed upon terms of equality in competing with national banks, it may be expected that progress toward uniformity in banking legislation throughout the country would be much more

rapid than ever before. This uniformity would be exceedingly desirable, since it would take away the possibility of evading legal provisions. At the same time it would prevent the transaction of undesirable forms of business that are sometimes undertaken by banks as a result of their being "played off" against one another by designing borrowers.

The tendency would be to segregate and harmonize into one general group all the commercial banks of the country whether organized under state or national laws. Those that did not choose to conform to the requirements laid down in the legislation, with respect to reserves, kinds of business done, etc., would remain out of the National Reserve Association and would at once be recognized as belonging to quite a different class of banking institutions. They would exercise in their way as good and effective a function as that performed by the banks, whether state or national, that had brought themselves into conformity with the provisions of the proposed reform, but their position in the community and the rules of their action would be quite different. They would be set apart, not as being state institutions, the line of distinction drawn at present, but as being institutions properly classed as not strictly banks in the proper sense of the term.

Banks Outside the Proposed National Reserve Association

§ 5. The question has been raised whether under these circumstances it is desirable or necessary to admit such institutions as trust companies and mutual savings banks to membership in the National Reserve Association. It must be admitted that in many instances these institutions are not now commercial banks and that, if they were to accept the requirements of the National Reserve Association, they would have to transform their character quite materially.

Trust Companies and Mutual Savings Banks

This whole question, however, really settles itself. It does so because the National Reserve Association plan necessarily limits the kind of paper that can be rediscounted by the National Reserve Association to certain specified classes. It is permitted to rediscount short-time commercial paper, it can purchase bank acceptances running not over 90 days, under certain conditions it can discount paper arising out of commercial transactions not exceeding four months' duration, and under conditions specified it can discount the direct obligation of a depositing member. Most of these classes of business could not be offered to the Reserve Association by savings banks and trust companies. Probably only the

direct discounting of their own obligations would be possible. In other words, the Reserve Association would not be of only indirect value to savings banks and trust companies that did a genuine savings bank and trust company business.

National Reserve Association Intended to Strengthen Commercial Banks

This is as it should be. The new institution is intended solely for the strengthening of the commercial banks of the country. The savings banks and trust companies would get their aid, if they did not choose to throw off their own character and become something else, from the same source from which they now get aid, the other regular institutions of the country.

Any plan whereby the Reserve Association would be allowed to make loans to such institutions upon the collateral security which constitutes in many instances the basis for the bulk of their present loans would open too large a possibility of danger. Such a course would present the risk of involving the funds of the Reserve Association in stock exchange securities. In many cases, the ability to grant aid to savings banks and trust companies by rediscounting their notes secured in the way already indicated would be very desirable, but the possibilities growing out of it would be too serious to permit of its consideration.

§ 6. The second point noted as offering a fundamental problem in connection with the establishment of state and national banks on a uniform footing was the equalization of conditions of legal regulation and government oversight between the two groups of banks. Some of the discussion already offered with reference to the equalization of business and competition has necessarily referred to this subject. The plan suggested in the National Reserve Association proposal calls directly for the assent of state institutions to conditions of examination similar to those imposed upon national banks. This would be an exceedingly desirable consummation. It has long been sought by the Comptroller of the Currency through conferences with state bank examiners and superintendents of banking to reach this very end. He has found in his experience that serious harm results from the discrepancies in the dates of examination of state and national institutions, while still more serious harm results from differences in method of examination.

Uniformity of Examination

Considerable progress has been made by the Comptroller toward the development of a greater measure of uniformity in regard to this matter. He has received encouraging responses to his overtures, from state superintendents of banking and from state

bank examiners. In the organization of a clearing-house system of examination the Comptroller has succeeded in securing an agency which will be important in its influence upon the uniformity of state and national bank examinations in the cities. State bank examiners in the clearing house cities undoubtedly will coöperate to a very material extent with national bank examiners and the representatives of the clearing houses. Such relations, however, are entirely voluntary and cannot be made effective, except so far and so long as the banks are willing to abide by them.

Clearing House Coöperation Aids Uniformity in in Examinations

It is not possible to carry the requirements of examination to the extent that is actually demanded by the circumstances of the case. Moreover, such relations have no basis in the country districts or in the smaller places where the banks are not organized among themselves. It is therefore almost necessarily true that under existing conditions there will continue to be large discrepancies in examination methods, just as there will be similar discrepancies between legal requirements governing the administration of banks and the kind of business they can perform. As things now stand, conditions will not be much improved through the changing of legislation by the several states with a view to establishing a uniformity of practice which does not now exist. That can be attained only in some other way.

It would be possible to reach it by the national reserve plan. In the requirements imposed in the suggested plan with reference to membership on the part of banks in the Reserve Association, it is specified that each member bank, holding stock in the concern, shall agree to submit to the same examinations and to make the same reports that are required by federal law. This will practically impose uniformity of banking control upon the state banks which choose to become stockholders in the National Reserve Association and thereby to get the advantage of its provisions. It would be a practical exchange of uniformity of examination and control as part of the price exacted of the state banks for their membership in the Reserve Association. This will go much farther than anything that can be accomplished by the Comptroller of the Currency under the plan which he is now endeavoring to enforce with respect to the banks.

Requirements of Examination in National Reserve Association Plan

§ 7. All that has been said with reference to the effect of the proposed Reserve Association in equalizing conditions of busi-

ness and competition, and in equalizing methods of banking and government oversight between national and state banks, is merely contributory to, and explanatory of, the third principal problem.

A Single Discount Market

This third problem was that of "the harmonizing of the interests of the two groups of banks so as to strengthen and unify the discount market of the country for the future." This is the essential purpose to be gained by the admission of state institutions to stock-holding membership in the Reserve Association. If the association were to be organized without reference to the state banks, it would leave out of account many of the strongest institutions in the country and would be obliged to depend entirely upon the national banks which had taken stock in it for the organization and conduct of the new institution. Doubtless the institution could be conducted on that basis. The effect of such an attempt, however, would be to put the commercial state banks which are in competition with the national institutions at a disadvantage.

It may be that under the proposed plan trust companies will still be at something of a disadvantage as compared with the national banks. But certainly the conditions will be far more nearly equal and far more nearly adequate under the proposed plan. The state banks, although organized under state law, will in fact be brought to a common and harmonious basis of practice with the national institutions, while a strong influence will be furnished tending to influence state legislatures toward the adoption of uniform banking laws based on those of the federal government. The general outcome will be to make the banking system of the country more uniform, the rates of interest more level, and the general position of the business community with respect to the banks more satisfactory.

Effect on Methods of State Banks

The immediate and direct outworking of this change will be seen in the development of a uniform system of discounting. State banks will apply the same standards in judging paper as do the national banks which are associated with them in the Reserve Association. They will endeavor to extend credit on the same terms to their customers. They will be inclined to send stock-exchange business and operations involving classes of paper which are not recognized by the Reserve Association to the non-commercial banks outside of the association. They, as well as the national banks, will conduct their business in all essential particulars along similar lines. The test of a bank's suitability for membership in

the Reserve Association will be found not in the question whether it has a state or federal charter but whether it is willing to accept the most rigid standards of commercial banking and to limit itself largely to specified classes of business.

New Standard of Banking Quality

This will do away not only with the discrimination which might otherwise exist against state banks, but with the lack of harmony of practice among the commercial banks which would otherwise result from the establishment of an elaborate rediscount system open only to national institutions or to institutions which might seek to gain access to it through the intermediation of the national institutions.

The effect upon the customers of the state banks will be beneficial in the same way and for the same reasons as with the customers of the national banks, and there will be no reason why any shift in the clientele of the banks should occur as between national and state institutions. At the same time, the trust companies, mutual savings banks, and others which distinctly carry on a peculiar type of business and which do not care to accept the restrictions proper to commercial banking will be permitted to continue their own kind of business, not only without disturbance but with an additional element of strength.

§ 8. Benefit to the outside institutions will be genuine. In the first place they will be relieved of the competition which in some cases they have experienced from national and state institutions. These institutions will be inclined more and more to restrict themselves to a purely commercial banking business. It will not be possible for them to comply with the requirements of the Reserve Association fully and completely and at the same time to compete along outside lines as unrestrictedly as they can at present. Whether the ownership of the stock of national banks and state institutions, including trust companies, by identical persons is to be continued or not is a matter for subsequent legislation, but whether it be terminated or not, the tendency of the new system will be to restrict and limit such combinations.

Benefit to Institutions Outside the National Reserve Association

More important than this is the fact that the outside institutions will be able to get accommodation for themselves from the national and state banks which are members of the Reserve Association in a way and to an extent that has not heretofore been possible. The various banks, feeling sure that their own short-time commercial paper can be converted readily into reserve funds,

Amount of Accommodation Will Be Increased

will be far more able to afford accommodations to state banks and trust companies which come to them with collateral of undoubted validity on the strength of which temporary accommodation is solicited. This is practically the situation which exists in foreign countries, where precisely the relations just described are maintained between the commercial institutions and the savings and private banks which are less limited than the former in respect to the kind of business they can do. With the bank acceptance system fully established as provided by the terms of the Reserve Association plan, the amount of inter-bank accommodation which can be granted will be greatly increased without any corresponding increase in the difficulty of maintaining convertibility. The benefits of the Reserve Association will accrue not merely to its members or even to its own customers, but in an almost equal degree to outside institutions and their customers. What strengthens the banking system as a whole will strengthen every element in it.

CHAPTER XVI

THE NON-BORROWER'S INTEREST IN BANKING

1. Interest in Banking is General—2. Relations of People to Banks—3. Interest of the Depositors—4. Safeguards for Interests of the Wage-Earner—5. How Bank Credit Reacts on the Laborer—6. Stability of Industry—7. Influence of the Supply of Money.

§1. Much of the discussion about banking is apparently based upon the assumption that the issue has to do only with direct customers at banks or at least with those who apply for loans. This is not the case. Every economic institution has its direct relationship to, and bearing upon, the well-being of every class in the community. This statement is conspicuously true of the banking system which supplies the machinery of exchange and production to so large an extent. A good banking system is of as great importance to the consumer and the recipient of wages as it is to the man engaged in distributive business or in manufacturing. When the banking system suffers, the injury is reflected with cumulative force through various economic groups until its limit is reached in the wage-earning and consuming classes in the community.

Interest in Banking is General

The bank stands in a two-fold relation to the community as a whole—meaning by that term those who are not necessarily customers of the bank or depositors with it, as well as those who, while using the bank as a means of convenience for the safe-keeping of funds, do not transact any business with it in which credit is bought or guaranteed. This two-fold relation consists: (1) in the supplying of a satisfactory means of exchange and in the safe-keeping of funds; and (2) in the maintenance of such credit conditions that economic opportunities, including the field of employment, the chances for investment, and other conditions of the same sort, are permitted to develop gradually and steadily without shock and in such a way as to preserve the welfare of every member of society.

Bank's Relation to the Community

Much is said about the "safety" of banks, and the national banking system has been highly praised because of the fact that its notes have always been redeemable at face value, while the losses to

depositors have been small when compared with the total liabilities. It remains true that a bank may be a very "safe" institution and yet a very unsatisfactory agency. Even from the narrowest standpoint, the mere maintenance of an ability to redeem its obligations is only the bare minimum of what should and must be required of an institution of credit. Little or nothing is heard of the bearing of bank credit upon the general steadiness of employment, the payment of wages, and the support of prosperous conditions. Yet all of these factors have a direct and intimate connection with banking. It is a severe criticism upon the national banking system that it has not done well when judged by the test thus indicated, and it is a strong argument for the introduction of a new system that it could do for the community in the directions just indicated, great service which is not now rendered by existing banks.

Safe Banks May Be Unsatisfactory

§ 2. The simplest form in which the bank is brought into contact with the individual is seen in the actual safe-keeping of money. The individual may have coin or currency which he does not immediately need to use and which he therefore deposits in a bank for safe-keeping. The bank is said to be sound or solvent if it is able at all times to return to individuals an amount of money equivalent to that which they have left with it.

Simplest Relations With Banks

A somewhat more complex form of relationship is seen in those cases where the individual has not left actual money with the bank but has deposited with it checks or drafts upon other banks (or upon the bank itself). In such cases, he has transferred to the bank a right which he might have exercised of calling for such money or currency as his checks and drafts entitled him to. The solvency or safety of the bank is tested in this case, as in the former one, by the ability of the bank to liquidate this title to draw which the depositor has received from it at the time when he gave up his checks or drafts to the bank.

Now the total amount of outstanding claims upon banks is always far in excess of the money which they carry in their vaults. Under the national banking system, the largest amount of reserve which any bank is compelled to hold is 25 per cent of its outstanding liabilities. This means that, even if every deposit with the bank had been directly made in coin, it might have used this money as a basis for loans to four times the amount of the deposit in question; in other words, it might have increased its liabilities to four times the amount of the money and currency on hand. It is evident that in such a case a solvent bank is so only in proportion

Claims Against Banks and Their Liquidation

as claims are not presented to it for cashing, since it could at no time meet the combined claims outstanding. If any considerable part of them were presented and a demand for liquidation into money were made, the bank would have to close its doors.

Plainly then the safety of the bank does not consist in its keeping on hand a large sum in money, since it never can expect to have in its vaults enough money to meet all possible claims. The safety or solvency of the bank is found in two conditions: (1) the possession of assets which can unquestionably be turned into cash, in sufficient amount to equal the liabilities of the bank, and (2) the possession of opportunities or facilities for converting these assets into cash so steadily and regularly that it will at no time be compelled, even temporarily, to suspend specie payments—that is to say, to ask its depositors to wait.

What Constitutes Solvency

§ 3. For many reasons, the depositor places great stress upon this ability to convert his deposit promptly into liquid resources. His credit at the bank may be all that he has to protect himself and those dependent on him and supply them with necessities. If the bank fails, his funds are "tied up" indefinitely, and perhaps are partially or even wholly lost. If the bank suspends, he is unable to get the current funds he needs to pay his ordinary "bills." In the first case, his savings are swept away and his interests are destroyed correspondingly. In the second case, he is obliged to ask others for credit or for leniency during the time that the bank has suspended. He is thus put to a very considerable inconvenience. During the period of suspension, demands may come upon him for cash which he is absolutely unable to satisfy. Opportunities for investment or for other uses of his funds must be sacrificed, simply because he cannot draw upon his own resources, which are now in a non-liquid form. Invariably therefore, he considers the maintenance of liquidity at his bank as essential and this requirement is so strongly entertained by him that in the event of suspicion concerning his bank's immediate capacity to meet its liabilities he may make matters worse by insisting that the bank pay him in full at once. If enough depositors adopt this course, the result is to make the situation much more serious and perhaps to drive the bank to close its doors. Ability on the part of the bank to meet a condition of this kind is therefore essential.

Interest of the Depositor

Judged by this test of safety and solvency, our banking system has been found wanting from the standpoint of the consumer and earner of wages. While the number of national banks that

have failed has not been disgracefully large, it has been large enough to cause fear in the minds of depositors. The record of the state banking system has been even less satisfactory than that of the national. But individual failures cannot be prevented and some will always occur. No system of banking is so safe or can be so protected as to avoid the necessity of care and judgment on the part of customers at banks. They must select their institutions with reference to the record and capacity that the institutions have shown.

A Point Where the Banking System is Found Wanting

Under our banking system, however, we have from time to time suspended specie payments completely, owing to the fact that a large number of banks feared their ability to meet their obligations and therefore found refuge in refusing to pay out cash until more normal conditions had been restored. This phenomenon has been observed at nearly every period of crisis or panic in the history of the United States. The effect of it has been to tie up funds for an indefinite period often lasting several weeks. Corresponding hardship has been inflicted during this period upon the small depositor.

Banks Have Refused to Pay Out Cash

The hardship has fallen with exceptional severity upon the laboring class in the community, because that class was more limited in its resources and its members were not usually able to get the extensions of credit from tradesmen that were accorded to others of larger means. As the average laborer conducts his affairs much more largely on a cash basis than the man of larger resources, he is correspondingly dependent upon cash at all times. The man who has no savings in bank has in such periods of stringency suffered worse than the man who had something on deposit, even though the latter might not be able to get money from the institution with which he had left his funds. The laborer who was absolutely dependent upon money wages from week to week or from day to day has usually found his immediate earning capacity annihilated, whenever funds were not in circulation, owing to the inability of banks to supply contractors and factory superintendents with the sums they needed for the payment of daily wages. Thus it has occasionally been necessary to suspend industrial operations at a time when conditions were otherwise fairly prosperous—merely because of a suspension of bank payments.

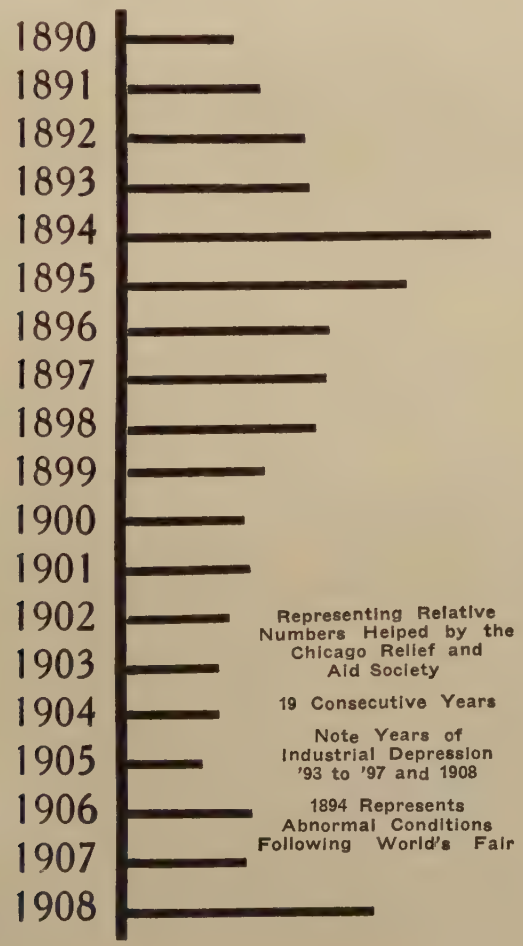
Wage-Earner Suffers Most

Besides the phenomena of suspension of specie payments, our system of scattered reserves and absence of general coöperation among banking institutions is responsible for the widespread havoc in the form of failures of banks and business firms which

accompanies every commercial crisis in this country. Only a small percentage of such failures is due to a lack of adequate and sound resources. Most of the failing banks and firms have been found to be ultimately entirely solvent, that is, able to pay a hundred cents on the dollar, and their failure due simply to temporary inability to convert their assets into means of payment.

Business Failures

The effect upon the laboring population of these widespread and long continued disasters is effectively presented in a recent article by Mr. John V. Farwell of Chicago, printed in "The Independent" of February 1, 1912. In the following chart Mr. Farwell graphically indicates the effects of the crises of 1893 and 1907 on poverty in Chicago:



Mr. Farwell also quotes the following letter from Mr. Sherman C. Kingsley, formerly secretary of the Chicago Relief and Aid Society, and the author of the chart, relative to their effects in other cities:

"The chart not only illustrated the situation in Chicago, but was fairly typical of the conditions in the large cities of the country. In 1894 I began this work, and I happened to be with the Brooklyn Bureau of Charities. The work there more than doubled. We resorted to all kinds of methods in an effort to give employment to people who were self-respecting, who had never before been obliged to ask for aid. The same kind of conditions prevailed in Boston, in New York, Philadelphia and other cities. Here are the figures from the Association for Improving the Condition of the Poor in New York: In 1892, $47,957, with 8,589 families; in 1893, $61,000; in 1894, $120,506; in 1895, $87,000. In Philadelphia, $20,962 in 1890, $19,875 in 1891, $19,320 in 1892, but $42,331 in 1894. In Baltimore, $7,320 with 7,769 applications in 1892, $9,278 in 1894 with 18,845 applications. In Boston, 8,020 cases in 1890, but 11,710 cases in 1894, with a similar increase in the amount expended.

"In Chicago, in 1906 and 1907, the Relief and Aid Society was giving about the same amounts that it had given back in 1890, and dealing with about the same number of families. In 1908, after the sharp panic arrived, applications doubled; the amount spent on relief more than doubled. A citizens' committee was appointed to canvass the town in an effort more adequately to meet the demands. Again we resorted to all kinds of expedients to create work for people who were thrown out of employment, and who, as in 1893, had never before sought help—strong, willing, able-bodied men begging for a chance to do something, and accepting makeshift work, cleaning streets, shoveling snow, sawing wood, doing anything that we could get to do and accepting a wage of about $1 or $1.25 a day, just enough to meet emergent demands. The municipal lodging house in 1908 became inadequate to take care of the men out of employment and annexes had to be created. Men lodged on police station floors—men who were self-respecting and anxious to work but for whom work could not be found. This all because something went wrong in the financial world. There are certain effects resulting from these paroxysms in industry which are lasting. Men go from day to day seeking employment and finding none. They come home at night and see the wretchedness of their families. They feel themselves a burden. They go elsewhere looking for employment. They become demoralized. They drink, they fall into evil habits, they desert their families. There is an undue amount of sickness incident to unusual kinds of exposure—standing on street corners, waiting in line for jobs—hundreds of them when only a

few are taken—all kinds of demoralization both of morals and health.

"The normal balance has been struck quicker after the panic of 1908 than after that of 1894. If one should draw a line through this chart, striking about a medium line of average causes of poverty, one would throw into bold relief a big section of distress due to panics."

§ 4. The real safety of the bank and consequently the safeguarding of the interests of the laborer and of every man who feels a direct reliance upon cash is to be found not in the maintenance of large supplies of money but in the ability to get accommodation, that is to say, to dispose of assets promptly as occasion demands. Banks that suspend and many of those that fail could be prevented from getting into difficulties if they were able to take their live assets to some institution which would convert them into immediate cash or its equivalent. Banks are frequently able to do just this through the assistance of other banks. But when the stringency spreads over the country, banks are not willing to let go their own funds for the sake of assisting others. Aid can then come only from coöperative effort which unites the resources of the banks and enables them jointly to cope with the difficulties that are presented to any one.

How Interests of Wage Earner May Be Safeguarded

This is exactly what has been done by the banks when they have united through clearing-house associations to extend accommodations to each other. The clearing-house associations have maintained solvency and sometimes liquidity and have thereby prevented institutions from going to the wall. But no permanent safeguard can be obtained whereby the small depositor will be enabled to assure himself of the immediate liquidation of his demands, unless there is a constant and permanent market for assets of a particular kind. Where such a market exists, the depositor secures absolute protection by dealing only with institutions which are known to invest their funds primarily in assets of this marketable description. If, through the organization of a coöperative National Reserve Association, such a market could be created, the interests of the small customer and particularly of the laborer who needs cash would be safeguarded as is possible in no other way. The interest of no class in the community is more intimately dependent upon a safe and steady market for rediscounts than is that of the person who wishes to be able to liquidate his claims on demand.

Co-operation Through Clearing Houses

The average man, however, no matter whether or not he is

able to get cash from his bank upon demand to the full extent of his deposit, is not materially aided thereby unless he is able to continue remunerative employment. Few wage workers, and perhaps comparatively few members of the community, have liquid funds on deposit with banks to an amount that is equal to their consumption for six months in advance. The total number of depositors in the national banks of the country was 7,690,468 in 1910 and their total deposits $5,287,200,000, an average of less than $700 per depositor. Assuming that the average annual wages of those who work for day wages are $600, it is clear that a very large number of persons are only a little ahead of ordinary requirements. Many even of those who possess bank accounts are "hard up the last 30 days in every month."

Effect of Banking on Field of Employment

This calls attention to the second requirement of the wage-worker in connection with banking. The system must be such as to assure him, so far as it can, the steady flow of funds that will enable him to restore his deposits when they have been drawn down by the withdrawal of cash for current needs. This reconstruction of deposit accounts comes only through a free flow of funds throughout the community, that is to say, through the steady payment of wages and salaries. This process is rendered possible only by the continuous activity of industry. But continuous activity can be obtained only in those cases where the business world is able to obtain freely and at reasonable rates the capital which is necessary to enable it to offer employment and thereby to secure the means of operating its plants continuously. When employes are able to do this, there is a free flow of funds throughout the community, and the laborer is able to get wages in cash in exchange for his services. If the flow of funds in this way is checked through inability on the part of banks to liquidate, the employer may desire earnestly to set men at work and laborers may be eagerly in search of employment but they will not be able to coöperate. In modern society, where labor is highly specialized and a machine type of industry prevails, wages are not paid in the products of labor but are paid from the previously stored capital which is kept in a fluid or liquid condition through the action of banks.

Free Flow of Funds Necessary for Small Depositor

§ 5. How a bad condition of bank credit reacts upon the laborer may easily be understood by considering the course of events at a period when bank credit is reduced. Let us suppose that employers are not unduly expanding their operations, but that they are

receiving a normal amount of credit from banks. Under those conditions, loans to them at the banks will be simply what is necessary to make their commercial paper liquid by giving them the advances they need, thus enabling them to anticipate payments which would come in to them from persons who have bought goods in the natural course of trade. It may be supposed that the paper which they are in the habit of presenting to banks is perfectly sound and that no exception is to be taken to it.

How Bank Credits Affect the Laborer

Now there occurs some event which tends to place a strain upon bankers. If these bankers are unable to dispose, in their turn, of the paper which has been discounted by them for customers, they will necessarily see their reserves declining as a result of the unusual demand to which they are supposed to have been subjected. The result will be that, in order to meet obligations which they have already incurred, they will be obliged to cease extending any further accommodations. The employer who has been looking to the bank to provide him with the fluid capital which he needs in carrying on his business will thus find himself cut off. Deprived of bank credit, he necessarily reduces those outlays which call for ready funds. In most mercantile or industrial establishments, the most important outlay is for labor, and the curtailment of resources invariably results in the discharge of men and consequently the cessation of their wages pending the time when business can get bank credit again.

The difficulty which is thus caused may be only temporary. But on the other hand, it may become so widely extended as to give a serious check to business. In this case, what is known as a depression may set in, its chief feature being the slowing down or even suspension of industry in a great number of quarters. Such depression means reduction of employment and more or less permanent restriction of the opportunities for earning wages.

The effects of such a period of depression are far from falling evenly upon all classes in the community. To the large retail merchant or manufacturer, the depression may not mean more than a restriction or abolition of his opportunities for profit. If obliged to curtail his personal enjoyments or expenses, such curtailment will not be of a kind that entails much hardship. He may be somewhat less prodigal and may endeavor to cut off some unnecessary outlays of large amount. Beyond this he does not go, since his accumulated resources continue to provide him with ample funds.

Effects of Depression Not Evenly Distributed.

The serious effects of the reduction in business activity are

felt by the employe in far greater measure. Precisely in proportion as he has been depending upon his regular earnings to provide for his necessities and those of persons who are dependent upon him, he will be affected by the reduction of employment. If he has accumulated no savings, he immediately becomes dependent upon credit for his support or is obliged to look to others to furnish him means pending the revival of business and the re-establishment of a demand for his services. If he has accumulated some savings, he is obliged to fall back upon these. Where banks remain able to meet all of their demand liabilities, the savings may be drawn out in cash and gradually consumed. Where they are forced by excessive strain on their resources and inability on their part to convert assets into immediate funds, they may be obliged to close, in which case the small depositor is placed in the same position for the time being at least, as if he had made no accumulation. Thus the weight of the shortage necessarily falls upon the employe either in his capacity of wage-earner or in that of savings-depositor or in both.

§ 6. The essential need of the wage-earner is stability in industry. Such stability can be secured only when industrial managers are supplied with all the elements of production. Of these elements, bank credit forms an increasingly important part.

Stability of Industry the Great Need

The claim may be made that such credit is not needed by all concerns and that only in an "inflated" condition of industry would it be needed or called for. It is assumed by some persons that the business man who borrows at the banks is an exceptional person. This is far from being the fact. Practically every business that is conducted upon any considerable scale requires accommodation. The accommodation in question is not "loans" as a general rule, but "discounts," in other words, funds which anticipate the payment of claims which the business has obtained against others in return for the services or goods which it supplies. In proportion as goods are sold upon credit, is it necessary that banks should intervene between the purchaser and the seller of the goods. The purchaser does not pay cash because he looks to the sale of the goods to provide the means for liquidating their cost. But the seller needs cash because he has to pay his employes in cash. He places his prices at such a point that he can afford to extend credit for a reasonable period. Then he draws upon his customer, and through the aid of the bank the draft is recognized and the funds are placed at his disposal for immediate use.

These transactions become more numerous and necessary in proportion as industry becomes highly specialized, and in proportion as more and more processes intervene between the original producer of raw materials and the person who consumes the product that has been developed out of them. The intervening stages through which the product goes represent repeated turnovers of capital and require time. The element of time thus becomes an important feature in productive enterprise, and this it is the function of the bank to allow. When the banking mechanism breaks down, there is a gap between the producer and the consumer which cannot be bridged.

The Question of Prices

§ 7. In proportion as credit plays a part in the process of producing goods it constitutes a corresponding element in the cost at which goods are turned out. The cost at which goods are turned out determines their price to the consumer upon any competitive market. The wage-worker spends the principal part of his income in purchasing commodities for consumption. He has to pay a correspondingly larger part of his income when the prices of commodities are high and is correspondingly relieved when they are low. Any element that can reduce cost is likely to reduce the price to the consumer. Wherever capital is an important element of cost, therefore, it is an important factor in determining how much the worker shall get in return for his money wages.

But borrowed capital is an important element in all modern operations. Whatever then results in high interest rates on loans at banks ultimately tends to produce higher prices for goods to the consumer. The consumer who is predominantly a worker for wages receives a larger amount in real wages—the things that money will buy, wherever industry is stable and bank accommodation is reasonable. It is a familiar fact in all countries where rates of interest are very high, that prices are correspondingly exorbitant and the result is that in those countries all goods that are produced with the use of borrowed capital are raised in price to an equivalent extent. While, therefore, the well-being of the general mass of the consuming and laboring population in the maintenance of a stable currency and a steady condition of business, free of panics and depressions, is very great, the interests of these groups in the community in the regular and systematic conduct of industry upon an economical basis is even greater.

Precisely for the same reasons that have already been sketched,

it is highly important that the community should, from the standpoint of the average man, be freed from fluctuations of prices. Such fluctuations may be due to many causes, but one large group of causes is found in connection with the banking system. Prices may rise owing to a natural shortage in supply or from some similar reason. This has nothing to do with the question of banking. But it frequently happens that artificial increase of prices is produced through the partial cornering of the supply of a given article. Such corners cannot be brought about, as a rule, without extensive banking accommodations. When such accommodation is afforded, the banks practically employ the funds of the community for the purpose of enabling given persons to raise prices to the members of the community.

Fluctuations in Prices

There is no satisfactory way of preventing such artificial movements of prices by legislation or similar precautions. The best safeguard against them is to prevent the speculative part of the community from securing accommodation at banks, certainly until after all the other elements have been disposed of. This can be done by a system which shall guarantee that the preference shall always be given by the banking system as a whole to paper originating in legitimate commercial transactions and in no way connected with speculative operations. If speculators wish to monopolize the supply of wheat, corn or cotton, they can do so ordinarily only by securing extensive accommodation at banks. But this accommodation necessarily deprives legitimate business men of the support they need or at all events makes the price higher to them. In proportion as the speculation succeeds, the consumer is injured, because he not only has to pay higher for the article which has been monopolized by the use of bank funds, but he also has to bear the burden involved in the higher cost of credit to the producer who is turning out the articles he wants to purchase for his own needs.

Bank Credit an Aid to Speculation

In the National Reserve Association banking plan, it is expressly provided that there shall be no loaning of the funds of the association upon speculative security. This is important in two ways—it places a premium upon the production of sound commercial paper and upon operations that give rise to it; and it discourages operations which are speculative in character or are based upon speculative securities. The excesses of speculation and the fluctuations of price which result from them are found in a far less aggravated form in those countries which possess sound banking systems than in those which permit the use of bank funds for specula-

tive purposes, either through lack of restraint upon bank operations or by reason of excessive competition among the banks and consequent desire to get business even to the disadvantage of the community.

§ 7. Closely allied with the considerations already indicated is that of the supply of money. A great quantity of money in a country is often referred to as an indication of prosperity or success. It is usually the reverse of this, in so far as it indicates anything, since it shows that the community has to maintain a large supply of a costly factor in exchange in order to get its work done. Those countries which are most carefully organized from the banking standpoint, have as a rule the smallest supply of actual money. Thus in 1910, Great Britain had $15.14 per capita of gold and silver in and out of her banks. The United States during the same year had $26.18. This signifies that in the United States we maintained in use a much larger amount of medium of exchange in order to effect our transactions than did Great Britain. In other words, we were obliged to keep that amount of money idle, thereby losing the interest upon it. The country with the smaller amount of money was at a correspondingly less expense in performing its operations for the same reason that a workman who has a given task to perform does not care to purchase more than enough tools to enable him to get through his work expeditiously and effectively.

Influence of the Supply of Money

In those countries where banking is organized upon a basis that economizes specie, this object is attained and the needs of the community for actual currency are supplied by currency issued through the banks and costing nothing except the expense of putting it into circulation and of maintaining a reserve for its redemption. Even where no bank notes are used, it is clear that the same purpose is served if there is an active circulation of coin and if the quantity of it needed is economized by making every piece as active as possible.

Needs of a Community for Currency

Examples of the latter condition are seen in those countries where coöperation in banking has tended to reduce the necessary amount of reserve carried and by massing reserves in a small number of institutions to keep them constantly ready for the relief of difficulty whenever such difficulty may manifest itself. Here the economy in the use of specie is obtained by avoiding the necessity of keeping a large number of small or isolated reserves while in the case first cited (that where actual currency is needed in many

Economy in the Use of Specie

transactions) the saving is effected by supplying cheap and abundant bank currency. In either case, the effect is the same—that of reducing the expense involved in the exchange of goods. This saving manifests itself in the form of lower commodity prices, just as cheap accommodations at banks tend to reduce the cost of an important element in production. Such savings are directly in the interest of the man who uses currency in the actual transaction of his business or in the actual purchase of commodities and necessities.

CHAPTER XVII

THE SMALL MERCHANT

1. Small Merchants Form a Large Group of Bank Customers—2. The Small Merchant and His Customers—Business on a Cash Basis—3. How the Bank Comes In—4. Bank Competition Prevents Discrimination—5. Benefit of an Institution for Rediscounting—6. Small Merchant as a Depositor—7. Handicaps of the Present Banking System and Advantages of the One Proposed.

§1. The small business man is particularly and peculiarly interested in banking facilities. He has demands for credit and bank accommodation as acute as any large merchant's without the latter's resources or power to force compliance with his needs. He is infrequently interested in, as a stockholder, or connected as a director with, any bank institution. His paper is not known beyond the locality in which he operates. No bank is specially eager to secure his business and he cannot send his paper abroad for disposal if he has urgent demands which, for any reason, his particular bank will not consider.

Position of the Small Merchant in Relation to Bank Credit

The merchant with small capital is, however, a decidedly important factor in every community, large or small. In the aggregate he is a great power in the nation. He supplies the needs of the ultimate consumer and it is through him the banks are brought into touch with the consuming masses and are thus made parties to the final process in the transition of goods from producer to consumer.

In the end it is this consumer who supplies the cash to discharge a credit obligation which may have originated in a loan to the producer of the commodity. At every stage in the various forms of transferring a thing from producer to final distributor borrowed capital may have been used and credit for it extended on the strength of the continued existence of the commodity. The ultimate consumer has no such security to offer. Once a thing is passed to him, it is destroyed or its value impaired by use. He must pay for it.

The Small Merchant's Relation to the Consumer

Broadly viewed, the banks must be keenly interested in the final process of the series which marks the progress of goods toward the goal. They must be particularly alive to the important position held by this small merchant. To a large degree it is on the ability to discharge his final duty that the success of the whole complicated scheme of production and distribution depends. His financial position and his means of using his capital and securing credit to carry on his operations are therefore of vital importance in any plan of banking or banking reform. His paper has its own characteristics. It is essentially local. The extension of credit to him is determined largely by the banker's knowledge of his personal dependableness and the character of the business in which he is engaged.

These characteristics distinguish the paper of the small merchant without regard to his location. His case is the same in the large city or small town. If he is in the latter, the field in which he may apply for loans is geographically restricted. If he is in the former his difficulties are not less because he must necessarily attach himself to one bank and look to that one for his accommodation. In every case his demand for loans is direct, personal and largely dependent for its satisfaction upon the judgment of the banker and his appreciation of the needs of this small client.

§2. Behind the small merchant are always the customers he serves. The extent of the credit to which he is entitled is measured somewhat by their willingness to buy and their power to pay. He may begin business with a small capital and make a rule that his customers shall pay him in cash or its equivalent. In such a case he will have few accounts outstanding at any time and his relations with the bank will depend on the adequacy of the funds with which he is operating. If his trade is good, he can turn his capital over quickly and transact a large business as compared with the amount of his original investment.

Security the Small Merchant Has to Offer

But even if this merchant sells only for cash, before his original stock is gone, it will be necessary for him to place orders with factories or jobbers for new supplies of goods.

Much of his capital is still locked up in the stock on hand and to convert it into cash with which to pay for the new supplies is impossible. He must either get credit from the supply men or borrow from the bank to carry the transaction to a conclusion. The

supply houses may be willing to give a term of credit of thirty, sixty or ninety days. This may be sufficient to meet his immediate requirements. If it is not, the bank must be appealed to.

In any event the bank comes into the transaction. If the supply house extends credit it has either borrowed against the merchant's obligation indirectly or discounted his direct obligation at its own bank. In the latter case the claim comes to the merchant's bank for collection when due. If the merchant can pay it, the particular transaction comes to an end. But if he cannot, and at some time payment will be impossible or inconvenient, he must secure an extension of credit. If he asks this from the supply house it will be at the risk of impairing his standing there. If he asks it from his bank, he must give satisfactory evidence that his business is in good condition. He must convince the banker that he has in stock goods of a value sufficient to protect the bank, that the stock is in favor with the public and is moving out into consumption. This is what he does and the bank gives him the necessary accommodation. The credit is, of course, extended on the merchant's obligation, which is practically unsecured. What the banker has is only the assurance that the state of the merchant's business warrants the credit.

How the Bank Comes Into the Transaction

In such a case the bank is obviously supplying part of the capital needed to carry on the merchant's operations. As a result he may carry a larger and more diversified stock than if he were dependent on his own resources. He can do more business than if he paid cash for everything he bought, or had to liquidate promptly at the end of the credit period whether he had sold the goods or not. It is true he is paying interest on this borrowed amount but he is gaining profits otherwise impossible.

In due course, as business grows, this merchant finds it more convenient and profitable to confine his credit business to the bank. Instead of buying on thirty or sixty days and paying at the termination of the period, he finds he can gain a profit by taking advantage of the customary cash discount. To do this he gets accommodation at the bank, not when his bill comes due, but practically at the time he makes the purchase. No bank transaction is commoner than this. In illustration: A is in business. His capital is $10,000. He buys a bill of goods amounting to $10,000. The terms of the sale are sixty days, subject to a discount of three per cent for cash. If he can borrow $10,000 from his bank at six

Cash Discounts as a Means of Profit

per cent, or one per cent for the sixty days, he can get the cash discount and so gain two per cent by the transaction, or $200.

In this case the bank practically pays for the goods. Morally, if not legally, it owns the goods and allows the merchant to dispose of them, holding them in his control in the meantime. One theory is that the goods, during the time of their passage from producer to consumer, are a proper basis for credit operations, the credit obligation being discharged by the payment of the ultimate consumer under whose possession they pass out of existence as merchantable commodities.

Banks which supply the credit which makes such enterprise possible are engaged in financing the business operations of the community. Their service is complete or incomplete according to their capacity to accommodate those who have legitimate demands and who need fluid funds. The extension of such accommodation by banks is one of their chief functions and of much importance to the public. It makes it possible for the merchant to sell his goods at closer figures and his customers share in his advantage under the compelling force of competition with rival merchants.

Banks Finance the Business of Their Community

§3. The merchant does not always do a cash business. Frequently when his capital is sufficient to permit him to do business on this basis it will not permit him to carry on an enterprise in which credit is granted to his customers. The kind of business he does is largely controlled by the habits of the community he serves. If this community is made up of persons whose incomes are received at long intervals, he must furnish supplies and wait for his pay until his customers secure money from their own operations. This is bound to be the case if his customers are farmers who are paid for their crops and receive very little cash during the remainder of the year. The situation is not greatly different if the community is made up of wage-earners who get paid once a month. In such cases the merchant finds that to hold his trade he must open "book accounts" with his customers. These accounts may not be paid oftener than once a month and perhaps once in three months. The time of liquidation of these accounts may be weekly, but in any event a large amount of business is done under this system and a considerable proportion of the merchant's capital is tied up in the form of personal credits. For these he has no security. If the bank did not stand ready to supply him with funds his

When the Merchant Does a Credit Business

Capital Tied Up in Book Accounts

operations would be hampered, his business would be restricted and his profits materially reduced.

Accommodation to the Community

In such cases the bank is practically granting accommodation to the community. It is extending loans to the customers of the merchant. Legally, of course, the obligation is the merchant's. He is responsible and the bank must have satisfied itself as to his capacity to make good any loss that might occur in the business owing to inability to collect accounts. Economically, however, the funds which are advanced to the merchant are really advanced to his customers, and the security which backs them is the general capacity of the clientèle of the merchant to pay its bills when due. If the bank knows that the customers are steady, reliable men, receiving regular wages, and that employment in the community is abundant, it will not hesitate to grant the merchant, that is to say, the community, the accommodation that is wanted. In its essence, the transaction thus carried out is simply an anticipation of wage payments, the goods being advanced to the consumers during the period when they are engaged in the occupations which will produce the funds necessary to pay for the supplies that have been furnished to them.

Consumers Pay for Service the Bank Renders

The service of the bank is thus that of facilitating the flow of goods into the consumers' hands at the time when they are wanted. The consumers have to pay for this service in the prices charged by the merchant, because he naturally is obliged to compensate the bank for its advances of funds, and his operating expenses are thereby increased. The longer the period of credit is, the higher the prices will be, and the larger the accommodation which has to be granted by the bank, and the rate of remuneration that will have to be charged for it. Presumably, the consumer gets more than a corresponding return in the shape of convenience, or he would not submit to this condition but would pay cash for his goods.

Merchant's Credit Determined by Ability of His Customers to Pay

In the case of such transactions loans are made by the bank upon the merchant's own personal note. Evidence of his solvency and ability to pay is secured from inspection of his stock, his books and accounts, from his statements or otherwise. If he has property outside his business which is within reach, the bank will feel the more confidence, but whether he has such property or not, the immediate test of the loan will be the character of the customers he is supplying and the nature of their own personal credit—the extent of their capacity to pay.

It is now clear why accommodation of this kind cannot be granted save in a "local" way. The fundamental basis of the whole transaction is the personal relationship which exists between the banker and the merchant, and the essential test of the security is found in the banker's estimate of the capacity and integrity of the merchant in his dealings with his customers. This is based upon general knowledge of the conditions in the community. No such knowledge, however, could be obtained except through careful personal study of local conditions, and this is the task of the banker whose clientèle is largely made up of merchants and business men who demand his aid in their operations.

The Banker's Judgment

The banker's judgment as to which members of the community are entitled to the use of the fluid funds of the community is therefore vital, because it results in entrusting the funds to the successful or unsuccessful individuals as the case may be. It places them in trustworthy or untrustworthy hands. It puts them where they will be wisely used or will be wasted. In the long run, the judgment of the banker on this subject is always right. If he makes many mistakes in judging the character of his customers and their title to accommodation, he himself is the loser and eventually must go out of business. He will then be succeeded by some one else whose judgment is sounder and better than his own. Probably there are few lines of business in which closer and more accurate scrutiny and knowledge of the details of transactions are needed and are actually obtained than in country banking or in city banking where the clientèle consists of retailers.

Discrimination by Banks Is Prevented by Competition

§4. It is often asserted that the character of the accommodation needed by the merchant makes him peculiarly liable to discrimination. The local bank is able to limit or ruin his business if it will, and at the same time to advance the business of competitors. This is a real danger where there is a monopoly in banking. In the United States with absolutely free organization of banks under both state and national laws, this danger is not great.

The banking business, particularly in small communities, is highly competitive. If a local bank is known to be making good profits, another is certain to be organized. Indeed, within recent years, there has been a decided tendency towards over-banking in many parts of the country. Where competition is keen, the tendency on the part of the banker is to extend credit too freely. He is disposed to accommodate a customer as long as there is a fair

chance of repayment. The temptation to allow the bank to become involved in unsuccessful business is strong because the banker recognizes that a refusal to supply the means desired may drive his customer to the institution across the way. Only careful bank inspection and examination can wholly check this evil. This must be supplemented by watchfulness on the part of the directors and officers of the bank.

The paper of the merchant, as has been shown, is distinctly local in character. The whole banking operation connected with it must, therefore, be carried on by persons familiar with conditions in the community where it originates. It is plain, also, that, under such circumstances, the limit to the loans which can be extended is marked by the banking capital available in the community. This banking capital is supplied by those who first organized the local banks and those who have subsequently made actual deposits of fluid resources.

Limit to Loans Bank May Make

If the capital of the community is adequate to the business going on, this is a satisfactory source of accommodation. If it is not, the bank must seek accommodation elsewhere. When it is necessary for the bank to take such a step the character of its business places it at a disadvantage.

As an illustration the position of a bank in a small community with a clientèle composed largely of retail merchants may be contrasted with that of a bank in a manufacturing town. The latter carries a considerable amount of paper for the local factories. If it wishes to get a rediscount from a large institution in a neighboring city, it probably has no difficulty. Offering as the basis for such accommodation the paper of the manufacturers, it finds they are well known and their credit is established. But the bank whose customers are local merchants is likely to encounter difficulties when it asks for a rediscount. Its customers may be solvent and trustworthy men but they are not widely known. The city bank has no means of testing their credit. It must rely entirely upon the judgment of the local bank.

Handicaps of the Local Banker

The situation is the same, even if the rediscount spoken of be not technically asked for, but if, instead, the officers of the small bank undertake to get accommodation from the larger on their own personal notes or in some similar way. The question in the end is always whether the large bank is willing to put its resources at the disposal of the small community in order to enable it to continue the expansion of its business. Frequently it is not

willing. Thus a very distinct limit to the amount of accommodation that can be obtained by local merchants is found to exist. They must, under present conditions, enlarge their banking capital if they want loans beyond a certain point; they cannot easily get them elsewhere.

§5. This condition of affairs would be very much helped by the establishment of a definite rediscount market such as would be furnished by the creation of a Reserve Association of the kind previously discussed. Such an association would be able to supply loans to banks that were in position to offer it prime short time commercial paper. Where the paper ran for four months it could be rediscounted under the proposed plan if guaranteed by the banks comprised within a local association. The plan would thus be in practice that of coöperation among local banks in order to get aid from the great source of banking capital representing the combined banking interests of the country. By thus organizing for mutual protection, they would secure the opportunity to get rediscounts to almost any reasonable amount for which they could offer bona fide commercial paper arising out of the actual mercantile transactions existing in their own towns. At the same time they would be able to avoid the danger of over-extension of loans, since they would be able to assure themselves of the character of the paper by the usual methods which are open to those who study credit. The knowledge that paper was to be tested in this way would exercise a strong restraining influence.

Benefit of an Institution for Rediscount

With good bank examination and with a general knowledge on the part of all banks similarly circumstanced concerning the type of transactions in which each was engaged, it would not be difficult to devise a system of guaranteeing one another's paper in the way suggested in section 27 of the National Monetary Commission's bill, which is intended to cover precisely this class of cases. It reads as follows:

> **Section 27. The National Reserve Association may through a branch also rediscount, for and with the indorsement of any bank having a deposit with it, notes and bills of exchange arising out of commercial transactions as hereinbefore defined, having more than twenty-eight days, but not exceeding four months, to run, but in such cases the paper must be guaranteed by the local association of which the bank asking for the rediscount is a member.**

An important effect of the scheme proposed would undoubtedly be that of reducing and rendering much more stable the rate of discount which now varies so widely throughout the country. The merchant, who borrows from a bank in a town of 10,000 inhabitants in Texas, is likely to pay a much higher rate than is charged to the merchant in a similar town in the interior of New York, though it is highly probably that the obligation of the Texas merchant will be considerably more liquid than that of the borrower in New York. This is because of the peculiar conditions surrounding the distribution of bank capital and the methods of handling local loans in the United States.

Discount Rate Would Be More Stable

The situation may be compared with that which exists under the Bank of France. The latter institution, through its branches, makes an immense number of direct loans to small merchants, many of them for extremely insignificant sums. It is able to do this at a very moderate rate of interest and to charge the same rate of interest throughout the country. This is due to the fact that it can turn its great capital in any direction, and can supply loans where they are needed at any time, withdrawing its loaning power from those regions where, for the moment, there is no active demand. A similar situation exists in other countries where a system of coöperative management of bank capital has been applied. In the United States, the same results would be obtained under the Reserve Association plan, although by a different method. The branches of the Reserve Association would be established only in a few places. The direct relationship with the merchant, the testing of his paper, and the extension of his loans would be carried on by his local banker, just as heretofore. But the Reserve Association, through its branches, would deal with the small local bank, would become acquainted with its paper as that of one of its regular customers, would rediscount it; or, when occasion demanded, would ask for a guarantee on the part of the association of banks to which the given institution belongs. The machinery would be different, but the result would be similar to that which is seen in France and other countries where banking is similarly organized. There would be an equalization and reduction of rates of interest, and at the same time there would be afforded an unlimited supply of bank capital so long as the community deserved it and could profitably employ it.

How the Bank of France Operates

§6. There is another aspect of this relationship between the local merchant and the bank. The merchant is invariably also a depositor at his bank, as well as a borrower. He is a depositor in a sense somewhat different from that which has been considered in another chapter dealing specifically with the depositor as such (Chapter XX). The merchant who borrows from the bank almost invariably takes his loan in the form of a book credit. He draws on this book credit in order to meet his obligations. He seldom asks the bank for actual money. Frequently, his customers pay him in checks and he deposits them with the bank. When they pay in actual cash, he promptly takes the money thus received to the bank. His deposits with the bank, whatever they may be, are frequently less than the amount that he owes the bank for the accommodation which has been extended to him. It is therefore vital to his success that he should be enabled to continue doing business with the institution without interruption.

The Small Merchant as a Depositor

A panic or stringency which compels the bank to call in its loans to him wipes out his deposit with the bank or compels him to get funds from some other source, perhaps at a very serious sacrifice. On the other hand, a check to business or to general solvency throughout the community means that his customers can not freely liquidate their obligations to him. In that event, he may have to ask for extensions of credit, or his deposits at the bank may be cut down below the figure which the institution considers necessary. In any case, he cannot go to the bank and demand liquidation of its obligations to him with the same assurance that exists in the case of a depositor who owes the bank nothing on his paper. It is, if anything, more important to him that the bank should be sustained in times of panic and stringency than it is to the man who has no dealings with the institution except to deposit his funds there and draw them as they are needed.

Mercantile Interests Bound Up With Bank Interests

For such reasons the mercantile part of the community is usually the strongest support of the banks simply because its interest is so closely bound up with that of the banks. The security behind the commercial paper of the community is thus not merely the actual property of the merchants who compose it but is also their commercial future and their general prospects of success in a business way. The paper which they supply to the bank is therefore one of the best bases for rediscount that can be offered. The assurance that it will be paid without default is as great as can be obtained.

§7. The local merchant shares with his community the penalties an inadequate banking system imposes, and he has some particular grievances in addition. Like everyone who has direct dealings with the banks he is the victim of the rigid reserve system. Under our banking customs and laws, emphasis is placed on the quantity of cash reserves. These are commonly held to be the test of banking solidity. Every banker, and especially the isolated country banker, is solicitous about his reserves. He sacrifices everything that they may not be impaired. At the first sign of trouble in the business world he grasps for lawful money to fill up his reserves. He stops lending. The only law he knows is that of self-preservation. He knows there is no place he can go with the assurance that he will get help.

How the Present Banking System Handicaps the Small Merchant

The country merchant, dependent on local bank resources, or the small city merchant, dependent on one bank, is the first to feel this suspension or curtailment of loaning power.

With a reserve agency would come coöperation among the banks. Under this system the power of a bank to lend would not depend on the condition of its cash reserves, but on the quality of the paper it had on hand. Instead of garnering cash and stopping discounts, it could pay out cash and make loans in the certainty that, with good paper on hand, it could get cash. Instead of increasing and intensifying a stringency by efforts to protect itself, it would contribute to end the stringency and restore confidence. No local merchant would ever be driven to failure by lack of banking accommodation and no bank would be forced into liquidation because of inability to convert sound assets into cash.

What Coöperative Banking Would Do for the Small Merchant

Such a reserve agency is more in the interest of the local merchant than of his bank. With a rediscount market established, the rate of interest would be the same to every bank, in any part of the country. In sparsely settled communities the small merchant may be forced by scarcity of capital to pay ten, twelve or even fifteen per cent interest per annum. A Reserve Association would bring capital to the points where it was most needed, that is, wherever good commercial paper was offered. This would be bound to lower interest rates. The local merchant, instead of being cut off from sources of credit, would have new ones opened to him. The only condition would be the quality of the paper he had to offer.

Interest Rates Under the New System

Under present conditions it is startling to discover that in the autumn, when bountiful nature is pouring her products into the

More Wealth Would Mean More Credit

warehouses, that is the time—of all times in the year—when it is most difficult to get credit. And yet paper based on the exchange of these products is the best in the world. With a Reserve Association abundance of products would provide abundant means of payment for them. The country merchant, dependent on the movement and sale of crops, is the one person who should be most interested in improved banking methods through the establishment of a co-operative reserve association.

CHAPTER XVIII

THE FARMER AND THE BANK

1. Seasonal Character of Agriculture and Crop-Moving—2. Farmers' Loans Under Present Banking System—Cycle of Money Movement —3. Difficulty Due to Inelastic Note and Credit System—4. The Remedy in Coöperation—5. Experience of Canada—6. Idle Funds and a Discount Market.

§1. It has been pointed out that more than half of our 95 millions of people live in the rural districts and cultivate nearly one billion acres of land. The valuation of agricultural lands and buildings is more than 34 billions of dollars. What is most striking of all is that the annual product of our farms is nine billions of dollars, or about as much as the entire resources of all our national banks; in other words, 10 per cent of one year's product of our farms would pay off the national debt. The capital invested in agriculture exceeds that invested in either manufacturing or railroad enterprises. The men who till the soil are creating wealth in the United States at the rate of about 25 million dollars daily. It may well be said, therefore, that the importance of the relation of the farmer to our credit and banking system is equaled by that of no other class in the country.

Farmers as Producers of Wealth

The obvious peculiarity of agriculture is that, owing to the character of our climate, in most cases but one crop per annum of a given kind is harvested. The significant relation of the famer to our banking system arises out of the fact that the harvesting of the regular staple crops of the country, such as wheat, corn, oats, cotton, and others, is a seasonal operation. This is the one important fact which distinguishes the financing of agricultural operations from those of industry and manufactures in relation to banking. In regions which are mainly agricultural, the seasons of the year when the products of the soil are being marketed are the seasons when large calls are made upon the banks for loans.

There are few lines of industry in which anything like the same seasonal character is found. Some classes of manufactures, to be

sure, are to some extent dependent upon climatic conditions—upon the spring or the fall trade. For instance, the general retail trade feels an upward movement at times when the seasons are changing, and a corresponding depression at the height of the season. But beneath this ebb and flow of trade there is invariably a steady current of exchanges which continues at nearly the same volume throughout the year and represents the normal consumption needs of the community.

Seasonal Activity on the Farms

The needs of the farmer, however, are peculiar. At the time of the year when the ground is being prepared and seeded, there is more or less demand for loans, but none of these are at all comparable to the demand for funds in the harvest season. After the crop has been harvested, the strain upon the banks is removed. Moreover, since the characteristic of agriculture means a seasonal income for the farmer, it gives likewise a seasonal character to other branches of business which are allied with agriculture. The business of the small merchant is a good deal more brisk after a large crop has been sold and paid for than it is at any other time. The milling of wheat is similarly affected. Likewise, there is some movement of the laboring population into the agricultural regions at the harvest time, and a movement from the farms into the villages after the harvest is over. All these conditions therefore create a peculiar seasonal problem for the banks to deal with.

Borrowing From the Banks to Move the Crops

During the planting and growing season of late spring and early summer the farmer of the Middle West has need for only a moderate amount of ready cash, even though a crop of considerable size is coming forward. Some money had to be spent at seeding time, and a certain amount was paid in wages during the growth of the crop. But the chief expense is that of harvesting, gathering the product in the barns or warehouses, preparing it for shipment, and actually taking it to the transportation line. When the wheat crop ripens, the farmer usually has not the ready money to pay out for labor and more machinery; in fact, he may have invested any surplus in extending his acreage or making permanent improvements. To pay his harvest hands and the consequent bills for additional food and farm supplies, he is likely to go to his local bank and obtain a small amount in cash. He requests a loan which may run for a comparatively short period. He may ask for it simply on the strength of his known credit in the community, or he may even secure it by a mortgage on his crops and farm material.

Perhaps the farmer has disposed of the crop as it stands to a middleman or agent, as is frequently done in the case of apple and other fruit crops. The middleman in that case may seek accommodation either at the local bank or elsewhere. If he has no collateral to offer as credit, he may furnish the bank with bills of lading covering the produce in transit to some purchaser who has bought the goods from him. Such a transaction would be possible only after a portion of the products had been gathered and delivered to the transportation company. Whether the demand for the loan comes from the farmer, or from some local purchaser of his products, the demands upon the banks are the same. The funds are needed for the purpose of setting the products in motion towards the consumer. The term of credit is the average time required to complete this movement; and the security is usually the products themselves.

Banks Must Provide Credit

§2. The local national bank of Wheatville, we may suppose, has deposits of $200,000; the law requires that $30,000 of this must be kept as a "legal reserve"; $12,000 of this $30,000 must be kept in its vaults in lawful money (greenbacks, gold and silver). If paid out the banking law is violated and the bank may be closed by the Comptroller. To do the ordinary business of the bank perhaps $5,000 in cash is needed, since the money deposited day by day about offsets the amount paid out. But in order to have funds in the big cities, on which drafts may be drawn to accommodate customers and to lessen the risk of keeping large sums in its vaults, the bank keeps part of its reserves in nearby reserve city banks, and smaller accounts at Chicago, St. Louis and New York.

Country Bank Reserves

The form in which the borrower wishes to get his accommodation from the bank is that which will be most acceptable as a means of payment to the persons he owes. In a city the borrower will generally make his payments by drawing checks upon the deposit account which the bank gives him as the result of the loan. In a sparsely settled country community where the number of banks is small and where the use of checks is not customary, the borrower will generally ask from the bank some forms of cash. The farm hands and others who are to receive the payments involved in gathering the crops prefer to have a medium of exchange which will pass current among them more easily than the bank check. This is usually satisfied by any form of cash. In short, during the crop-moving period, the banker must bear in mind that he must meet an

urgent request for various forms of lawful money or bank notes. Some of this currency does not come back to the bank; the hired men may keep it until the end of their jobs, then travel on, and finally carry the money back to their homes. Hence, while the local bank may have paid out $10,000 a week in cash, only a portion of this amount will have returned to the bank in the deposits of merchants. Finding its supply of money running low, it sends to its reserve center—perhaps Kansas City, Omaha, or Minneapolis—for a shipment of currency. Hundreds of other banks are doing the same thing, and the city banks soon find their own supply of reserves decreasing. Thus they make requests on Chicago or St. Louis. There a demand is felt from thousands of banks over a wide area, and they consequently send to New York, where they keep a portion of their reserve funds, asking for large shipments to be sent from the East to the West. Thus the same pressure which is felt by the local bank is inevitably transferred with constantly increasing intensity to the banks of the central reserve cities of St. Louis, Chicago and New York.

Autumn Crop Demand for Cash

The seasonal characteristic in the agricultural regions is, as we have seen, not confined to the farm; in such a community, the mill or the local buyer of grain also needs loans. During a period of about three months the mill must secure wheat and corn enough to insure a supply throughout the entire year. It is, of course, impossible for it to carry through the other months of the year actual cash for that tremendous expenditure. The management therefore borrows from the bank the funds for buying grain. A small country mill may need as much as $20,000 to $40,000. Since the mill will be purchasing the farmers' grain, the mill must have the cash to complete the purchase; consequently the demand of the mill on the bank is likewise a demand which must be met in cash. The loan to the mill may have a maturity of several months—that is, for a period covering the grinding of the wheat, the shipping to a distant customer, and the return of the payment. A car sent to New York from the Prairie States may be eight weeks on the way. The mill is paying interest on the loan, and the amount of this loan, whether high or low, correspondingly affects the working expenses of the mill, and it must be met by a charge on the wheat producer or on the consumer—either in a lower price to the farmer for his grain, or in a higher price on the flour to the consumer. That is, a clumsy and expensive banking system inevitably lays its tribute upon the farmer or the consumer.

Millers' Need of Bank Credit

The farmer, moreover, often appears as a business borrower. He may have harvested 40,000 bushels of corn; he may have had a large hay crop. If he could buy 200 head of range cattle to fatten he could make a fine profit on both his grain and stock. He may ask the bank to give him a loan on a note properly secured, and with the credit buy the stock. Or, it may be that the farmer has a fine lot of young cattle, but has no feed for them. In that case he would wish to borrow the money with which to purchase hay and corn. Thus the bank must carry that loan until the cattle are fattened and sold—a period of perhaps three or four months.

Farmers as Business Borrowers

The seasonal characteristic of agriculture also influences the business of the local merchant. The small merchant who keeps a supply of farmers' necessities may carry a stock of goods worth perhaps $20,000; but a part of that is bought upon credit. He must, to hold his trade, frequently buy new supplies from the city. To obtain this added capital he needs a loan until he can sell the goods. This can be obtained either by a loan from the bank, or the wholesale house must give him 60 or 90 days' time. In the latter case, the wholesale house is itself probably the borrower from a city bank. In one way or another the banks collectively must meet this seasonal demand.

It will be observed that the cash obtained by the farmer from his bank is soon paid out for supplies or labor. The money sent from reserve cities into country districts requires some period of time before it comes again into the local banks. In the autumn the farmer may not sell his wheat at once; he may haul in one or two loads at a time, for, perhaps, $45 a load of 50 bushels. He takes a check for the money from the elevator or mill, and cashes it at the bank. The farmer's family may go to a county seat or a larger town at some distance where there are more pretentious stores and distribute some of this cash away from home. In this case the small country bank feels the prolonged demand for currency, and may be obliged to ship in considerable sums, even late in the autumn. Taking the banks collectively, however, the expenditure by the farmers for goods will inevitably result in the return of the cash by the merchants to the banks. The farmer begins to prepare for winter; tax-paying time arrives; the holiday trade opens; the farmer goes to town oftener and spends more freely. The local bank finds each day that it closes its business with more cash on hand than the day before; it ships a few thousand dollars to its nearest reserve center; thence it is shipped to St. Louis or Chicago; and in turn those

Return Flow of Currency

cities send more or less on to New York, until the tide of currency is running back to the financial centers of the country from which it was drawn early in the autumn. Thus there is an ebb and flow of actual currency from the financial centers to the agricultural centers for several months. Then there follows a stationary period stretching on until the call of the harvest is repeated. Although more than 95 per cent of the wholesale transactions of the country is done with checks, actual money is demanded because of the seasonal characteristic of agriculture.

Difficulty in Supplying Bank Notes

§3. From what has been said, it is clear that banks in the agricultural parts of the country are expected to be able to provide notes, while the customers of banks in other parts of the country may do their business largely with checks. When the country banks are called on for loans, they should be able to provide notes of their own issue. Under our present system, however, they find themselves obstructed by the limitations upon national bank currency, that is, the rigidity and inelasticity of our system works a direct injury to the country bank and to the borrowing farmers. They must first provide themselves with government bonds, then go through with the formalities attendant upon the issue of the notes.

In very few cases where a bank in an agricultural region has a good trade, is it able to satisfy the wants of its customers by simply lending them its own notes. This means that it must supply itself with funds from some other source. The only source from which it can obtain what it needs is the other banks of the country. Hence, in order to have a resource upon which it can draw at crop-moving periods, it must build up a credit account with some bank elsewhere. This it endeavors to do. It is allowed by the national banking law to place a part of its reserve with the banks in reserve cities and central reserve cities, and to the sum thus fixed it seeks to add by remitting such exchange on the cities as comes into its possession in the course of the year. When the crop-moving period arrives, it draws on its correspondent bank in the city for actual funds. The correspondent bank ships the money, usually in the form of paper currency, to it by express, and thus it is able to supply the wants of borrowers. If the point is reached where it cannot further draw down its account with the city bank without danger or without violation of legal requirements, it must either stop lending or else ask the city bank for accommodation. The latter can be had by obtaining a straight loan or a rediscount from

the bank—the result being in either case to increase its credit with the correspondent bank and hence enable it to draw on that bank for the resources it actually needs.

Of course the process just sketched is not an isolated one. It is going on simultaneously in many parts of the country, and although the height of the crop season is not the same in all parts of the Union, owing to the difference in the dates at which given products mature and owing to climatic variations, there is enough of simultaneous demand to subject many banks to strain at about the same time. Therefore, all over the country there is likely to be a general call for funds which will take cash out of the vaults of the banks and keep it out for a certain period. This is a situation against which the city banks endeavor to provide by furnishing themselves with note issues, in many instances, which they would not otherwise take out. But, even when they have thus protected themselves, the demand for loans is likely to be so irregular and subject to such variation that the protection is inadequate. Even if it is sufficient, the cost of issuing the notes, as outlined in an earlier chapter of this volume, is so great that the expense of furnishing loanable funds for crop-moving is invariably high. Whether the city banks be called upon, therefore, to extend accommodation in the form of reserve money or in that of their own notes, they must charge a tolerably high price for such accommodation.

General Call for Funds Cuts Down Reserves

Consequently the borrower must pay a more than equally high price. If the city bank has to part with reserve money (or, what is the same thing, is called upon to extend a loan to a bank, knowing that that bank will promptly call upon it for cash), it recognizes that the making of this loan will be a decidedly serious thing for it, since its credit-extending power in its own community will be cut down in proportion to the amount of loans that could have been supported by the reserve money with which it parts. If it has to get out notes expressly for the purpose of satisfying a borrower, it ties up a part of its fluid resources in the form of bonds, or else it borrows the bonds and pays their owners for the use of them. In any case, therefore, the operation is expensive. This expense is thrown upon the borrower in the form of a higher rate of interest. The home bank charges him whatever it has had to pay to the city bank, and in addition such a rate as will compensate it for its own services in acting as an intermediary and practically guaranteeing the loan made by the city bank. Such action is inevitable, and of course involves no criticism upon the banks which thus

High Rates to Borrowers

charge a double rate for the accommodation they extend. But it makes the cost of supplying credit with which to move the crops abnormal. Inasmuch as the credit obtained is a part of the expenses of production in any economic operation, it is a part of the cost of placing agricultural products on the market. As the price of such products, in so far as they are staples, is a world price, they are necessarily less profitable to the producer than they otherwise would be. This means that there is an unnecessary burden upon the farmer as a result of our present system of agricultural loans.

How Panics Hit the Farmer

The method in which a stringency or panic affects the agricultural section may be shown by what happened in the autumn of 1907. As has been explained, farmers, crop-buyers and banks were drawing on the large reserve centers for currency. Suddenly, because of financial disturbances, there came runs on certain New York banks which compelled caution on the part of all other banking institutions of that city. This local situation, together with heavy demands for currency from the agricultural belt, made it impossible for the New York banks to satisfy all demands and also keep their currency reserve up to the point required by the banking law. They were compelled to refuse currency shipments to Chicago, St. Louis, Memphis, New Orleans and other points; consequently, the banks of those cities could not assist Minneapolis, Omaha, Kansas City and the cotton belt without illegally lowering their own cash reserves. In a day the entire country was alarmed; everybody wanted his deposits in cash, and there was not enough to go around and no possibility of getting more. This account explains fully why the New York banks are equally interested in obtaining a measure of banking reform by which the coöperation of all the banks would relieve the pressure upon themselves as well as upon the small local bank.

The local banks had the notes of merchants and farmers—all good commercial paper—but they had no cash to pay out and yet retain their lawful reserves. In such a case the bank of Wheatville, for instance, has $12,000 lying in its vaults, but it can not use it. It may have $200,000 of deposits and $25,000 of capital, but it may not be able to loan more than $160,000 to $170,000; it must keep as legal reserve $30,000, that cannot be used and, for safety, or in a moment of slightest alarm, it tries to keep its reserve in excess of the actual legal requirements. Likewise, every other of the national banks in the United States has

a portion of its reserve in gold or other cash, but under the present banking law it cannot be used. Depositors, therefore, are compelled to wait. Loans become expensive to the farmer.

The essential need of the farmer or producer is a cheap source of credit that will enable him to send his product to market at a reasonable cost. This source must be one that can provide him with note currency, since, for the reasons already noted, that is a form in which he prefers to take his loans. He gets his accommodation in the best shape when it is in the form that is most acceptable to the people whom he has to pay and, as we have seen, that is the bank note, or actual reserve money of some kind. This kind of accommodation must be supplied him at as low a cost as is consistent with a fair return on bank capital and with the character of the paper the farmer has to offer. In the majority of cases the security offered by such farm product loans intended for crop-moving is of the best. The cotton bills of the South are well known for their reliability, and the same is true of similar paper based upon any staple crop, such as corn, wheat, oats, etc., in transit. As stated before, it is not a matter of much importance whether these bills originate with the farmer himself or not. Whether they originate with him, or with some factor or middleman, the cost of getting the accommodation from banks to cover the period while the goods are in transit or while they are being held to await a higher price is reflected back upon the farmer, in the form of a lower return. In so far as he can offer, therefore, paper of the very best description either directly or indirectly, there should be no reason why he should not get credit at the lowest going rates. His necessities call for a large, well-recognized market for paper of the kind he has to offer and an expansible or elastic medium into which his bank credit may be transformed.

Cheap Money the Need of Agriculture

§4. Our antiquated banking system, which has remained practically unchanged since the Civil War, is obviously working in a destructive fashion upon the farming community. When the Bank of Wheatville has loaned to the farmers, elevator men and merchants all that its resources warrant, it must stop lending; under our present banking laws, it has no method of expanding either its credit or its currency. The farmer may offer his note secured by wheat or stock and the bank cannot accommodate him; the mill may have 50,000 bushels of wheat in store, but it cannot

Agriculture Hampered by Banking System

use that as security to borrow from the bank. The bank's only resource is to send the paper elsewhere, trying to find, if possible, some other bank not loaned to its full capacity.

It is not creditable to the intelligence of our country, more than half of whose 95 millions live in the rural districts, that there should be a perpetual and unnecessary struggle between the lending institutions and the borrowers. There ought to be some method by which the farmer, merchant and dealer in grain or stock can obtain credit when he needs actual currency. It has been made clear that any complication of the machinery by which it is made difficult to get credit means a lessened business opportunity for both the farmer and the merchant, and directly or indirectly results either in lower prices for the producer or higher prices for the consumer.

The obvious remedy would be a coöperative agency by which all the banks of the country would be united in a national reserve association. Thereby the banks in any section where pressure arose would be able to bring the combined capital and credit of all the banks of the country to the assistance of the region at the time when it was most in need. As a consequence, no bank would be obliged to refuse accommodation to its customer, if it possessed good commercial paper; because the local bank could take that paper to a branch of the national reserve association—free from dependence upon any city correspondent bank—and, with the proceeds of the loan, immediately increase its lawful reserves and its ability to lend to its constituents. When the Bank of Wheatville needed more currency at any time, it would change its credits with the national reserve association to notes, which would be sent to it without charge from the branch. Thus the notes of the national reserve association would automatically expand and contract, in accordance with the ebb and flow of the seasonal demands. Instead of each bank working out its salvation alone, all the banks would work together under a general policy.

Coöperation the Remedy

§5. The experience of other countries shows that it is not necessary to have a stringency, great or small, at periods of crop-moving, but that the seasons when agricultural products are being sent to market can be financed as easily as any other productive period. This can be done by supplying the two fundamental necessities already referred to. In Canada, where the system

of production is very similar to our own, results are obtained by means of an elastic note issue which expands as the demand for agricultural loans expands. This note currency is supplied through a large number of branch banks which are thrown out into the agricultural districts by strong, highly capitalized institutions. The branch banks gets the notes from the head offices as fast as they are wanted, and lend them to farmers on the strength of the staple agricultural security which the latter have to offer. This system is often referred to as a flexible note currency system for moving the crops. It is, in reality, a flexible system of bank credit which happens to take the form of note currency. It fulfills the two requirements already mentioned in a preceding section. The large banks which establish the branches constitute the market for the paper of the agricultural communities. With their head offices situated in commercial centers, and with branches located in manufacturing regions, they are in position to draw idle funds from all sources and mass them where they are wanted at crucial moments. They thus afford a genuine market for agricultural paper. On the other hand, owing to their ability to issue large volumes of notes, they can supply the accommodation in that form and do actually do so.

How Canada Helps the Farmers

But while the branch system is desirable in many ways, it is not necessary, provided there be established such a system of coöperation among banks as to give to every institution which is called on for accommodation beyond its immediate means to grant, a certain and assured opportunity of marketing the paper which is offered to it and thus of getting the backing of a strong institution which will supply the support that is needed. Where this is done the result is to furnish exactly the same means of accommodation which are supplied under the Canadian banking system. If a coöperative institution were created, with power to issue notes as they were wanted, it could rediscount the paper presented by small banks. Having meanwhile obtained from other banks the surplus funds of other communities, it is able to use these as a basis for other loans and thus to afford genuine accommodation to the banks that are in need of it. This accommodation would naturally take the form of bank notes in the agricultural regions of the country. It would not matter whether the loans were made in the form of notes or in the form of credit deposits, so far as the maker of the loan was concerned, but it would

Branch Banks

be a matter of great importance to the individual borrower. The service of the note-issuer would be merely that of converting into immediate means of payment assets which would be almost immediately wanted by the community and which had a certain market at a definite figure. There would be no reason why any higher charge should be made for this kind of accommodation than for any other; and as a matter of fact, there would not be.

Low Interest Rates In Remote Sections

A comparison of the rates of interest charged in the United States with those charged in Canada shows a very decided difference. In the United States (see table of interest rates of national banks given in Chapter III) the rates are uniformly high in outlying sections. In Canada they are little, if at all, higher there than in the commercial centers. Differences in paper, the length of the loan required, and other factors of the same sort, lead to some differences in rates of interest, but otherwise rates are uniform. In the United States the charge for accommodation at farming points in Texas may be 10, 12, or 15 per cent at the same time that in New York there is a plethora of idle funds which are being loaned at 3½ and 4 per cent. Probably the rate on the loans in our country districts would never fall as low as this, for it often happens that the inability, under our system, to shift banking capital to different parts of the country as it is wanted causes a rate of interest which is as abnormally low in the cities as it is abnormally high in the country. With fluidity in banking capital and equality of adjustment between the two forms of bank credit, it would be found that a medium rate of interest somewhat higher than the abnormally low rate of the present day and much lower than the abnormally high rates which prevail in the country at present would be established. There would, in short, be a general adjustment of supply to demand in the matter of bank loans and accommodations.

Market for Agricultural Paper

§6. The establishment of a regular discount market for paper originating in the agricultural communities, and the provision of a suitable note currency would be of great advantage in another way. The problem of the bank in the agricultural community is two-fold—how to get additional means of accommodation at the crop-moving time, and how to dispose of its surplus funds at other times. The bank during a large part of the year now has difficulty in disposing of the funds which are left with it. When farmers are paid for their crops and have liquidated their loans

at the bank from which they borrowed, there is a surplus which represents their remuneration for their own labor and the use of their land during the producing season. This surplus is deposited, while at the same time the demand for loans falls off heavily. The local bank tries to keep its funds active by buying commercial paper elsewhere, or by redepositing with other banks which pay it interest. When the funds are thus employed, the bank can afford not to seek loans of the less secure or less fluid character which may be offered in its own community—in other words, it can adhere closely to the actual business of banking from the commercial standpoint.

Purchase of Outside Commercial Paper

The purchase of the outside commercial paper may thus be a good thing; and the redepositing of its funds with other institutions, or the lending of such funds in distant markets, may be a good thing. Unfortunately, it frequently happens that the funds which are thus lent at a distance are lent upon speculative security. Sometimes, although not so often, the commercial paper which is bought by the bank is bought unwisely and results in a loss to the institution. Under the most favorable circumstances, there is probably a larger chance of loss, or of unwisdom in such use of the funds, than would exist if the bank could use them in buying paper which had been tested by a large coöperative institution or by an existing bank that afforded a market for such paper. Thus, a discount market would be of great service to the bank, not only in marketing its own paper in times of special pressure, but also in keeping its funds active. At the same time it would be relieving the necessities of other communities which had a surplus of paper at times when the first institution had a surplus of funds.

The effect of this discount market would be most obvious in the aid it would afford to banks in keeping their funds active and thereby enabling them to earn a good profit. But it would also have a favorable effect upon the borrower at the local bank. As we have seen, the local institution has to charge an exceptionally high rate because of the irregularity of business, which is abundant at some times and deficient at others. If it could be relieved of this irregularity, and enabled to employ its funds at about the same rate, and on about the same terms, throughout the year, it would be able to supply accommodation at a charge that was practically uniform throughout the year and that varied only as

the general supply of, and demand for, loans varied throughout the country. In this way, a discount market would work in the interest not only, and not even primarily, of the banks, but to the distinct advantage of the borrowers at those banks. The local institution would be much better able to invest its idle funds as well as to get the use of idle funds from other places. In working out such a system, therefore, the business community would be promoting the interest not merely of the banks, but of everyone who was in the least dependent upon bank credit to facilitate his operations.

Discount Market Would Promote Uniformity of Interest Rates

The plan suggested would really amount to a means of economizing the use of capital throughout the whole agricultural community. At present there is very great waste in the use of capital, owing to the necessity of holding it idle for long periods. The tendency of banks in some places has been to employ their surplus funds in long-period loans on real estate and similar security. This kind of business the national banks have technically been cut off from doing. Much of such business has, therefore, been taken over by state banks. This creates competition between different classes of banks. In not a few sections of the country, the effect of this competition has been to lead banks to undertake real estate loans by roundabout methods which violated the spirit of the national bank act, notwithstanding that they observed the letter of the law. Where this has been done, the effect may be to enable the banks to get better returns on their capital, but it is more than proportionately injurious to the community when the time comes for active short-period loans to be used in moving the crops. At such times, it is found that, in so far as the bank's capital has become involved in long-period security, it is unavailable for current uses. It is then so placed as to work a reduction in the active loaning power of the bank. This simply means that, in the attempt to get a full return on their investments and keep their capital actively employed, the banks have really reduced that portion of capital which is in a shape to furnish the basis for commercial loans. Under such circumstances, the banking capital of the community is narrowed by that amount. The community is then driven more and more to rely upon distant banks in time of stress. To the extent that it is thus obliged to look elsewhere for its short-period accommodations, it is without real banking capital. The function of banks as such in an agricultural community is not that of fur-

Present System Causes Bad Banking

nishing farm loans, which are to be employed in the making of permanent improvements or the extension of farmer's equipment. That is a kind of business which should be performed by savings institutions, or by companies specially organized to do a mortgage business. The function should be kept quite separate from that of banking, as the type of organization which can be relied upon to furnish loans of the one class cannot be relied upon for the other.

The adoption of a plan for rendering the crop-moving process efficient would aid the banking system as a whole, and through it would cheapen accommodations to borrowers in urban centers. The discount market would be materially aided by the offering of agricultural funds at slack seasons for the purchase of paper originating in manufacturing regions or in retailing and jobbing centers. It would thus greatly tend to broaden the regular market for paper originating in either of these quarters. But it would also tend to create a new field for the exploitation of city bank capital. It has been noted how and why agricultural communities call for note credits rather than book credits. Conversely, we have seen, city communities demand book credits and do not care for many notes. At the present time, city banks take advantage of this condition of affairs, so far as the cramped conditions of note issue under the national system will permit them, to issue their own notes and to place these in the country when there is a demand for crop-moving "money." Very much more could be done in this way by an institution which was vested with a genuine note-issuing power. Inasmuch as the demand for the two kinds of bank accommodation is not interchangeable, it is usually true that a bank can maintain a considerably larger volume of outstanding credits where it has the power to make use of both classes of accommodation instead of employing only one.

Broader Market for Commercial Paper

If a coöperative institution representing all the banks were thus vested with a large note-issue power, it would practically call into operation a large resource of credit which is now not employed at all. This kind of credit may be considered to have the same relation to the deposit form of bank accommodation as does the by-product in an industrial operation. If a manufacturing concern is throwing away, or not utilizing, the material for the production of an important by-product, it is not in position to sell its chief output as cheaply as it could were it realizing something for its waste material. In a similar manner, the fact that the

Benefits to Other Sections of Country

banks of the country were employing their power of sustaining a note issue would call into effect a source of revenue which would enable them to supply credit by the other means at a lower rate. The steady call for note currency from the agricultural districts would, in other words, imply a possibility of keeping the rate on ordinary loans in the cities and manufacturing regions considerably lower. This is the interest of the ordinary business man and manufacturer in establishing a system of good agricultural credit. The desire for such a system of credit is not a purely altruistic one with him. It is coupled with the effort to make his own credit more secure by freeing the banks with which he deals of undue demand at periods of exceptional stringency. This makes it possible to reduce the regular charge to him for the credit he needs, at all periods. Agricultural in a country like the United States is one of the basic industries of the nation. Whatever tends to render that industry more stable and regular in its methods, and at the same time to lower its cost of production, necessarily produces a beneficial reflex effect upon the rest of the community.

CHAPTER XIX

THE MOVEMENT OF COTTON

1. Financing Import and Export Business.—2. New York Supplies Cash to Move the Cotton—3. How Cotton Is Bought From the Producer—4. Defects of Present Banking System in Relation to the Cotton Movement—5. Cotton Movement and a Discount Market—6. The Bill of Lading—7. Acceptances.

§1. The South, through its ports—New Orleans, Galveston, Mobile, Savannah, and Charleston—is engaged in the importation of such products as coffee, or bananas, from South and Central America; or in the exportation of such a main staple as cotton to Europe. In both cases, the transactions give rise to credit instruments by which shipments of actual cash are saved. That is, bills of exchange (or drafts) from different countries are offset against each other in international bookkeeping with much the same general effect as are checks on different banks within our country offset against each other at our clearing houses. To show the working of a National Reserve Association upon Southern business and banking, it will be well to discuss: (a) The matter of exports; and later (b) that of imports. Under (a), the points taken up will be:

International Bookkeeping in Export and Import Business

(1) A description of the present movement of cotton, and the bills of lading arising therefrom
(2) The present financing of this movement by the banks
(3) The evils of the present system
(4) The remedies offered by a National Reserve Association and acceptances
(5) The bills of lading question

§2. The total value of unmanufactured cotton exported from the Southern States in 1910 was $450,447,243.00 (or 6,263,293 bales). Under present conditions, the main part of this movement of cotton is financed through New York, and the profits thereby gained are variously estimated at several millions of dollars.

New York Finances the Cotton Movement

The question has been raised whether the Southern banks might not be able to do more of this business at home. Of course, it is a question, also, of the use of capital during the crop-moving season; and the South itself does not possess the available capital to meet the need when it comes.

In the technique of the cotton movement, it may be well to distinguish between (1) "domestic bills" and (2) "foreign bills," the former based on the operations within the country up to the arrival of the cotton at the port of shipment, the latter arising from the over-sea movement by ship. It is to be remembered that about one-half of the cotton produced is consumed at home. Hence domestic cotton bills between different parts of the United States are many; and they are also related to questions of warehousing. bills of lading, and the demand for credit. But times requires that this study should be confined to the cotton intended for exportation.

First Steps in Moving Cotton to Market

A cotton factor, or merchant, at some place like New Orleans, or Mobile, has cotton from various parts of the South sent him on consignment, or under some agreement as to price, to be sold. Or, a buyer sets out to purchase cotton in any part of the producing area. In such cases, the cotton comes in on a railroad bill of lading, running only to the domestic port, or place of shipment; and if this cotton is sold to an American mill, or to another shipper, only domestic bills of exchange arise. In case the factor sells any of this staple for export, he delivers it from the warehouse to the purchaser, who loads it on the ship and then obtains an ocean bill of lading. It may also happen that the foreign buyer himself may purchase cotton in the interior, and, wishing to see the actual goods, or collecting small shipments together at the seaboard, he may have the cotton sent to him on domestic railroad bills of lading; then, afterwards, when he loads it on a steamer, he obtains a separate ocean bill. Thus, two sets of bills of exchange and bills of lading arise, a "domestic" and a "foreign;" but each covers an entirely separate transaction. If this distinction is kept in mind, much confusion may be avoided in understanding the financing of the crop.

The method of handling cotton for export varies, of course, according to the conditions prevailing at the moment. At times the foreign buyer may find it advantageous to buy the cotton from the supply which is always accumulating at the seaboard. But, as is well known, there are throughout the producing area what

might be called inland cotton centers, such as Memphis, Dallas and the like, where the commodity is accumulated from the surrounding country. Consequently, the purchaser for foreign account may buy cotton at these interior points and ship it direcly abroad on what is known as a Through Bill of Lading. This bill of lading is issued by the railroad, and designates that the cotton is to be carried to the seaboard and thence by steamer to a specified foreign port. At the seaboard, such cotton is transferred without being touched by the shipper; but, when the cotton is placed on shipboard, the shipper obtains a document known as the Master's Receipt. This document, however, does not control the shipment nor enter into the negotiation of drafts. The bill of exchange on Europe is negotiated on the through bill of lading, which controls the delivery abroad in the same manner as a simple ocean bill of lading. In this case, one set of bills covers the entire transaction.

The Through Bill of Lading

§3. Such being the usual course of the cotton movement, it will be the next step to indicate the present method of financing these operations during the months from September to January.

In regard to the local cotton business, it is to be mentioned that the transactions are always in cash; hence a buyer, A, if of good standing, will arrange with his local bank to obtain funds if he wishes to purchase cotton. As is usual in this country, A will give his demand note, and secure it by warehouse, or compress, receipts, or by railroad bills of lading, covering a certain number of bales of cotton. Conservative banks will not advance on this form of security more than their capital stock and surplus; but this amount of credit is not adequate, and it makes the movement of cotton difficult. Moreover, if done, it is expensive. Payments for cotton are demanded in cash. Consequently, when A buys 1,000 bales of cotton and gets the loan for, say $60,000, the bank knows without any doubt that within three or four days it will be called on for $60,000 in currency, which must come out of its reserves, or must be shipped to the bank from the central reserve cities. When the cotton movement is over by January, this currency comes in, and must be returned again, chiefly to New York. It is estimated that approximately $200,000,000 of currency is thus sent into the South, and again shipped back, during these four months, at a cost to country banks of possibly $40,000.

Flow of Currency When Cotton is Moving

In the thirteen cotton-growing states, including Kentucky and excluding Missouri, there are 1,461 national banks with a combined

capital stock of $159,927,430. When this capitalization is considered in connection with the value of the cotton crop it becomes immediately obvious why the South has to call on the North and on Europe for aid when the crop is to be moved. And, since the whole crop-moving period makes patent the insufficiency of American capital for all the demands—grain- as well as cotton-moving—put upon it, the inevitable resort is to Europe. And the ninety-day bill of exchange is the usual form by which this borrowing is carried out.

Financing Export Shipments

In regard to financing exports of cotton and foreign buying, the operations are as follows: A cotton buyer, A, in the Southern States, having borrowed as above described from his local bank, will now make a contract with a spinner abroad, or with a foreign cotton buyer (one who sells cotton to mills abroad), to sell him, say, 1,000 bales of cotton of a particular grade and staple, for shipment at a stipulated time and at a certain price. This price is usually what is known as "C. I. F. & 6%," *i. e.,* cost, insurance and freight, and 6% tare deducted. Having assembled the requisite number of bales, A takes out an ocean bill of lading for them, drawn to his own order, and stipulating that the steamship line shall notify the person abroad to whom he has sold them. He then makes up his invoice for the net amount which the foreign buyer should pay him and draws a draft (or bill of exchange), payable ninety days after sight to the order of himself, and endorsed in blank, which is called a documentary bill, because A attaches to it the ship's bill of lading, or the through inland bill of lading (as previously described, covering both railroad and steamship transportation), and a policy of insurance covering the shipment. This draft, or bill, is drawn either upon the cotton firm to whom he has sold the cotton, or upon a mill which purchased the cotton, or upon some bank whose name has been given by the purchaser as one that will accept the bill by arrangement with him (the foreign purchaser). The Southern cotton buyer, A, then presents these documents to a bank, which offers him (for a commission) the equivalent in dollars for whatever foreign money the bill may call for. By the proceeds of this sale of cotton to Europe, A has funds with which to take up his loan from a local bank, if he wishes.

Of course, foreign cotton bills may not be sold to a local bank in the South. A may sell through a broker in New York to some bank. Then the local bank, from which A first borrowed on his demand note, may draw a domestic bill of exchange, with the or-

iginal documents (warehouse receipt) attached, on the New York bank. Thus, in another way, the local bank will gain the sum necessary to liquidate A's obligation to it. Of course, the broker in New York gets a commission for selling the bill of exchange; and the New York bank makes a profit on the bill of exchange.

Acceptances and Bills of Exchange

Next, the bank forwards this bill, or draft, to its correspondent abroad, who presents it to the person upon whom it is drawn, and has it accepted—this acceptance being made by writing across the face of the bill the word "accepted," with the name of the firm, mill, or bank, and the date.

The bill of lading and the insurance policy are thereupon delivered to the accepting institution, and the acceptance is held for the account of the American bank which forwarded it; and it may be carried until its maturity, or it may be discounted in the foreign discount market and the proceeds placed to the credit of the bank in this country. Finally, the American bank can sell a demand bill against the proceeds of the discounted ninety-day bill, and thus obtain the funds to meet the bill on maturity, or, in the meantime, to continue similar operations.

§4. Having described the existing methods of shipping and financing the cotton crop, the defects of the present system may be here briefly mentioned.

Actual Money Is Needed

1. There is a lack of actual currency during the crop-moving period, and a plethora at other times. This lack arises from the inelasticity of our currency: greenbacks and silver are issued in fixed amounts; and the bond-secured national-bank notes increase (they do not decrease) according to the prices of bonds, irrespective of the demands of the South or of any other community. To the extent that transactions are increasingly settled by checks rather than by actual cash, the conditions are changing for the better; for, as more banks are established in the interior of the Southern States, there is a greater use of checks; but at present, and, as this condition may not soon be changed, the movement of the crop calls for many millions in circulating notes.

2. Even when it is possible for Northern banks to increase their note-issue, the annual requirement for currency to be sent in from outside during the movement of the crop brings with it certain expenses and difficulties. Since there is but one agency, and that at Washington, there is great delay and

expense attached to the forwarding of national-bank notes. Moreover, the banks find it impossible at any time to change large notes for small ones, and *vice versa,* and, in consequence their customers are seriously inconvenienced. In addition, there is a high charge—seventy-five cents per thousand—for telegraphic transfers of currency from the New York Subtreasury to New Orleans.

Inelasticity of Note Issues Felt in the South

3. The necessity of shipping actual cash into the South in the autumn months, and the expenses involved in this operation, are, in themselves, only signs of causes lying deeper down. In the main, these are two in kind:

(a) One is the retention of really primitive conditions of exchange. Cash is required where credit-offsets might be more generally used. Because of the rigidity of our bank-issues, the inelasticity of our note system is painfully apparent. This is especially true in regions where checks are not generally used. No part of the country suffers more from the inelasticity of our note-issues than the South.

(b) But the inelasticity of the notes is really traceable to a more fundamental cause. That cause is the patent insufficiency of Southern capital to meet the exceptional demands of moving a crop valued at from $700,000,000 to $900,000,000. It is absolutely necessary to obtain credit from centers where the capital of the world can be drawn upon; that is, Southern banks are obliged to call upon their large city correspondents for credit. In ordinary times, such credit is freely obtained; but, in any serious emergency—such as a real stress or panic—credit is actually unobtainable. If credit were easily obtainable, then the transfer by check, as a medium of exchange, would be possible, even if notes were scarce.

Cotton as a Basis of Credit

Hence, apart from the inelasticity of notes (which entails difficulties and expense), the fundamental difficulty is the inelasticity of credit. Even though cotton in bales is as good a basis of credit as anything in the world, the banks of the South are restricted in their operations by an existing system, which, the moment a strain is put upon it, cuts them off from accommodation when it is most needed. As soon as a Southern bank's loans rise to a point where its immediate liabilities (in its deposit

account) are no longer in the legal ratio to its lawful reserves, it must cease to lend for the moving of cotton. And, if large city banks are also restricted in the same way, they cannot lend to their country correspondents. And it is unfortunately true that when the country banks are "loaned up," the city banks are likely to be in the same condition and for the same reason. The absence of any coöperative organization of credit, by which the reserves of all are put to the common service, hits the South in the cotton-moving period harder than any other part of the United States. That is, in any part of the country where capital is as yet insufficient for its needs, the lack is not so much a lack of currency as it is a lack of credit; if the credit can be had, then a medium of exchange can be got, either in the form of checks or (with some delay and expense) in the form of notes. The remedy, therefore, must be suited to the need.

South Handicapped More Than Any Other Section

§5. The plan of a National Reserve Association, in the form of a coöperative agency for all the banks—which is not a central bank—would enable any bank having cotton paper, accompanied by warehouse receipts or bills of lading, to obtain a rediscount at any branch of the Association. The proceeds of this loan might be had either in a credit on the books of the Association, or in the note-issues of the Association; and in either form (under proper restrictions) the borrowing bank would be able to use them in its reserves. The point of this operation would be that good cotton bills would carry with them the power to finance themselves, without resort to the aid of banks in the Central reserve cities. That is, cotton could be immediately transmuted into current funds during the period between its purchase and its sale. Such an institution could not be used for the promotion of syndicates, nor for carrying stocks and bonds, nor for providing funds to be used in speculation; because the only paper (in normal times) accepted for rediscount would be short-time commercial paper (such as ninety-day cotton bills). Such a plan, moreover, would be open to all banks, state or national, *and the rates of discount to subscribing banks would be uniform throughout the Union.*

Cotton Crop Should Finance Itself

This National Reserve Association would do no discounting with the general public, and hence would not compete for deposits with existing national and state banks and trust companies. Con-

stituted in the common interest of all the banks, it would make the credit of the whole Association available to the banks in that part of the country where the special need might arise.

Amount of Business a Bank Can Do

It is not always realized that the amount of business a bank can do is related, not to the volume of its capital and surplus, but to the quality of the paper it discounts. There is no possibility of undue expansion by a bank if its discounts are confined to credits based on cotton, in warehouse or in transit. Loans on such goods, by early sale for cash, carry within themselves the means of quick liquidation. Such paper is far and away safer than long-time bonds, which do not fall due for a considerable period, and do not possess any advantage over other property in being convertible into cash Such a coöperative agency as a National Reserve Association, therefore, is, by its very nature and operation, adapted to meet the peculiar difficulties which confront the South during the movement of the cotton crop.

1. It has been seen that cotton dealings are uniformly settled in cash; that the enormous burden of moving cotton causes the shipment of hundreds of millions of dollars of currency to and from the South in the autumn; and that the inelasticity of our note-issues makes currency scarce and high. Any demand for cash draws down the reserves of banks. When the surplus reserves are gone, the legal reserves cannot be paid out. In consequence, the banks cannot lend, even when good cotton bills are presented. This intolerable, humiliating, and rigid inelasticity of our currency would be entirely removed by a National Reserve Association. If a bank in Atlanta, Mobile, or New Orleans, during the crop-moving period, found its reserves down to the legal ratio, it could take cotton bills to the Branch (not to New York banks) and obtain notes of the Reserve Association which it could hold or put into circulation. That is, notes would come into existence just in proportion to the need for them as the cotton was moved. *Instead of a big crop-movement creating a money stringency, it would bring a corresponding supply of notes. Instead of a production of vast new wealth from the soil causing a stoppage of credit, it would, as it ought to, enlarge it, and bring prosperity with it.* Then, since the notes of the Association would be redeemable on demand in gold or lawful money, their return for redemption should be forced by some provision which would make them costly to the banks

Wealth From the Soil Would Bring Prosperity

to hold in reserves. Consequently, there would be the necessary contraction, after the demand for them had passed, which is as essential to elasticity as a ready expansion in time of need.

By such a coöperative association the South would be enabled to coin its own cotton into notes through its own local associations; and there would be no reason for the expensive shipment of cash to and from New York. Moreover, by making the South dependent only on itself, it would be freed from its present dependence for credit on New York, or on other central reserve cities. More than that, under the present dependence, it is often not able to get the funds, even if it has the cotton paper to be rediscounted; but, under a National Reserve Association, it would be safely provided with currency, if it so desired, just in proportion to the amount of cotton bought and sold.

No Reason For Getting Cash From New York

2. Not only would the coöperative organization of banks in a National Reserve Association provide elasticity of notes, but, more than that, it would provide an elasticity of credit. The one essential fact forced home on the South in the autumn is the inability to get credit. The value of the cotton crop is too great for her banking system to handle. But credit must be had. The bill of exchange for ocean shipments is the instrument used to get funds. How can the South get these funds, instead of feeling annually this aggravated constriction?

Under a National Reserve Association, aid would be given in a striking and effective way. Even if notes were not required, a bank, when threatened by a shortage of cash, would need only to present cotton bills having a short maturity to the nearest branch for rediscount. A credit would thus be created on which the bank could draw; or, the Association would even ship to it notes free of charge. All the items of present expense, as above enumerated, would disappear. The main point of this result should not be regarded as the convenience, or gain, to the local bank; the real substance of the new order would be the ability of the bank to accommodate its customers. Here is the crux of the whole matter: The persons to be benefited most are the borrowers, *i. e.*, the cotton factors, the cotton growers, and the whole public dependent upon the industry—the farmer, the laborer, and the storekeeper. If they are enabled to realize on their crop, their

purchasing power becomes evident at once.

Now why could a National Reserve Association work this miracle with the insufficient capital of the South? Simply because, as a coöperative agency, it would be enabled to call to its aid the mobilized reserves of the whole country to support an intense temporary demand; and because, by discounting bills for the banks, it could draw upon the capital of the North and of Europe. This capital would be available to the South whenever necessary, without begging for it, without asking for it, but as a natural outcome of the operation of the system. Why the South has not demanded some such institution long before is passing strange. Certainly there is no reason why it should remain content with dependence on New York, especially when, in times of emergency, that center responds to requests for aid only with the greatest difficulty.

South Would Be Independent Financially

It will be of interest to give here the opinion of a French banker, expressed to a friend in Atlanta, who is here quoted:

> "He is manager of the second largest bank in France, and the fourth largest bank in the world. He said that he was in the South for the purpose of studying its banking methods, and, if possible, to obtain accounts for his bank; that, to his great surprise, he found that the banks in the South commenced to advance money to make the cotton crop as early as January, by supplying the farmers with funds to purchase mules and fertilizer, and that such security as we took from farmers would not be considered good in his country; that we advanced a large amount of funds for labor in planting the cotton crop, which might never materialize, or be injured to a great extent, thereby making our collateral subject to weather conditions; that later on we advanced further large sums for the purpose of picking the cotton and preparing it for the market, and this he did not consider good security. After the cotton is picked and ready for market, the Southern banks advanced more funds, taking as security inadequate warehouse receipts. In fact, our entire system of banking was based upon the problematical security of a growing crop, which is not always certain. He stated, further, that, to his great surprise, he found that when the cotton is shipped and the security put in the form of a sixty- or ninety-day bill on bankers in Europe (which is in every respect equivalent to a demand on the Bank of England or the Bank of France), that we Southern bankers will not advance a dollar on the security, and the only explanation he could get was that we did not know how to do it; and this is a simple truth. We take all the risk of growing the crop, and the poor warehouse system, and when we get a document on which there is absolutely no risk, we refuse to handle it, and let this gilt-edged security go to New York, where it is handled at a good profit."

Further, by the instrumentality of a National Reserve Association, the financing of the cotton crop could be accomplished at home; the cotton bills could be drawn and sold by

Southern banks; and all the profit on handling the export of cotton could go to them, rather than to New York.

3. It is to be remembered, also, that the National Reserve Association should be empowered to deal in foreign bills of exchange, provided they arise from commercial transactions (as opposed to dealings in investment securities), and bear at least two responsible names. In such a case, with an agency in London, the gain from the transactions would accrue almost entirely to home institutions. A bank in the South having bought a cotton bill on a firm in England could forward it to the London Branch, which would present the bill to the acceptor. The accepted bills then in the hands of the Branch could be discounted in the open market in London, or in New York or Chicago. Thus the profit would be gained by the National Reserve Association, rather than by a foreign bank. Yet in this case, as elsewhere, the bill of exchange would enable foreign credit to be used in and for the South.

4. In the proposals for banking reform, it is also intended to allow all banks, under proper restrictions, to create acceptances. That is, instead of borrowing in the form of a demand note, the borrower, A, would make an arrangement with his bank to buy a bill drawn on A by B (the planter), or accept one drawn by A on his bank. Thereby, when accepted, the bank would assume the risk of repayment, and give the paper uniform security wherever the bank was known. The quality of the paper would no longer vary with the standing of the individual borrowers, but would be as good as the bank that accepted it. Consequently, such acceptances could be sold to investors in any discount market, at home or abroad, where the bank was known.

New Instruments of Credit

For instance, a cotton merchant at Greenwood, Mississippi, might arrange with his home bank, or with a bank in New Orleans, or in some other city, to grant him credit for $60,000. He would draw a bill of exchange, or draft, on the given bank at sixty or ninety days, to which would be attached the warehouse receipts. When this bill had been accepted, the paper could then be sold in any open market; and the bank could obtain at any time funds for such bills. So long as the credits were based on actual warehouse receipts, there could be no over-expansion. Over-expansion could

arise only if acceptances were granted without the actual security.

No Danger of Over-Expansion

Obviously, the introduction of acceptances, which would also be handled by the Branch of the National Reserve Association, would enable a bank to provide for a customer a credit instead of currency (or notes of the National Reserve Association, if so desired). Hence, a Southern bank could with safety extend loans based on actual cotton receipts to two and a half or three times the amount of its capital and surplus. Consequently, the lending power of the Southern banks in the crop-moving period would be doubled or trebled, not only to their own profit, but to the advantage of their customers, and the whole people.

5. Since these acceptances could be sold in the open discount market for prime bills, they would command a low rate of discount; and, if negotiating in Europe, the South would obtain its capital for crop-moving purposes at the low European rate, rather than at the higher New York rate (as at present). If the Southern banks could thus borrow at low rates on acceptances, they could grant lower rates than now to the merchants and farmers who form their constituency. For a small bank could borrow at the National Reserve Association at exactly the same rate as the large central reserve city bank. That brings out the democratic character of the proposed National Reserve Association.

Importance of Uniform Rate of Discount

The importance to the South of this uniform rate of discount by the National Reserve Association cannot easily be exaggerated. As things go now, the idle funds of local banks go to New York banks, are there loaned on call, and used for stock speculation. If acceptances were made possible, under proper restriction, and idle funds were directed to buying them in the open discount market at, say, 4 or 4½ per cent, instead of the 2 per cent obtained on New York deposits, the banks, as well as the borrower, would gain; the former getting a higher rate, and the latter a lower rate, than now. More than that, the flow of funds into call loans, as at present, makes the rate which the mercantile borrower pays depend upon the rates current on the stock exchange. But, with a National Reserve Association rediscounting only commercial paper, and with acceptances to be had in the open market, the mercantile borrower would be protected against

aberrations due to the excitements of stock exchange speculation. Not infrequently, in times of emergency—when a borrower is most in need—the rates in New York have advanced as high as 100 or 150 per cent. Likewise, the variation in the rates throughout the United States is wide, even in normal times:

New York, 2½-3 per cent
Chicago, 3½-4 per cent
Atlanta, 5-6 per cent
Macon, 6-7 per cent
Greensboro, 8-10 per cent
Smaller towns, 12-15 per cent

Small Banks Would Have Advantages

Under a system by which mobilization of reserves was made possible, the rates to banks in the smaller towns, on the same kind of security, would be as low as to the large bank in New York or Chicago.

6. The effect of the National Reserve Association would be far reaching in many ways. At present, the central reserve city banks value the accounts of their correspondents according to the amount of their deposit accounts with them. The rules of the New York banks as to balances and discounts regulate the amount of credits to the Southern banks. And at some times in the year their funds in New York are available to them only at a discount.

Cuts Off Brokers' Commissions

But if bills and acceptances were made in the South and forwarded direct to London by the Southern banks, the South would have credits in London for sale. This practice would eliminate the commission of the New York broker, and the Southern banks would retain for themselves the profit of the New York banker. Having cable advices as to rates of discount with their European correspondents, the Southern banks could make a price for exchange to the local cotton exporter. Having accounts in London, Paris, Berlin, or Bremen, the Southern bank could buy bills on Europe, forward them to its European correspondent, where the rate charged would be the European (not the American) rate; on this account it could draw its clear demand bills, or cable transfers. That is, it could sell its European credits wherever in the world (New York, Chicago, Rio Janeiro, Buenos Ayres, Montreal, or Havana) credits on Europe were desired. For example, if Brazil were buying manufactured goods from London, and ex-

porting coffee to New York; and if the South were exporting cotton to London; then the Southern bank could sell a London credit (in sterling) to Rio; and the Rio bank could cable New York to place the sum (in dollars) to the credit of the Southern bank. This whole arbitrage transaction could be completed in twelve hours.

London Accounts Have Advantages

As compared with a New York account, the London account is more satisfactory to the Southern bank. It is not so much a question with the London banker what the amount of the balance with him is; he is not rediscounting, as is the New York banker; he permits the Southern bank to draw on him, and he simply accepts the bills, charging for the period it is carried a rate of preferably 1½ to 3 per cent—a rate much lower than that of New York. The London banker values the account according to the amount of acceptances he gets; the greater the number and amount of bills, the greater his commissions. The credit is forthcoming in exact proportion to the need; while in New York it is dependent largely on the amount of balances held, or on the rigid system of reserves.

§6. Finally, we come out upon the bill-of-lading question, which has recently occupied so much attention since fraudulent bills were disclosed and efforts were made by foreign bankers to force a guaranty of the genuineness of the bills of lading before discounts were granted.

The risk attendant upon such transactions to the American banker is primarily whether or not the cotton was actually sold by the buyer in this country to the buyer abroad; and secondly, whether or not the firm upon which the draft is drawn really authorized its acceptance. It is therefore incumbent upon the American banker to be thoroughly acquainted with the person from whom he buys, and to be satisfied of his integrity and that he would not offer for sale a bill of exchange drawn against cotton which had not been actually sold, nor draw upon a firm or bank which had not agreed to accept it. The American banker operates upon the theory that his responsibility as to the validity of all the documents ceases when the bill has been accepted; and the only responsibility he runs thereunder is by reason of his endorsement on the bill, in the event of the failure of the accepting bank or firm.

The risk to the foreign cotton merchant lies in whether or not the American cotton buyer from whom he has purchased the cotton is honest and responsible. He may be defrauded in various ways:

Ways of Defrauding Foreign Merchants

(1) The foreigner may have purchased the cotton at a stipulated price and the American buyer may never deliver it to him, if the market advances sharply and the transaction would show a serious loss;

(2) The American may deliver him cotton of a lower grade than that which he purchased, and draw for the value of the higher grade;

(3) He may ship him cotton of less weight than that for which he draws;

(4) He may make out a fraudulent bill of lading by signing the name of an interior agent, and draw against the cotton without ever having shipped it.

It is therefore incumbent upon the foreigner to be thoroughly informed as to the firm or person from whom he buys, *i. e.,* in the same manner in which it is necessary for anyone extending credit to be conversant with the affairs of the person with whom he is dealing.

The risk to the foreign banker who has agreed to accept such documents lies in whether or not the foreign spinner or cotton merchant for whom he has agreed to accept is financially responsible and able to pay the draft, even though the cotton may never have been shipped. He is, therefore, required to exercise his judgment in the same manner as when extending credit upon any other piece of negotiable paper. In the main, the risk arising from the possibility of fraudulent bills of lading is no greater than the risks which the banks assume every day in the chance of paying forged checks.

Fear of Fraudulent Bills of Lading

If the European methods, by which the buyer of cotton arranges with his bank to accept bills drawn at thirty, sixty or ninety days against shipments of cotton, were generally introduced into the South, much of the fear as to fraudulent bills of lading would disappear. The local Southern bank would be over-careful to see that the bills of lading were genuine, if it accepted the bill and assumed the risk; and its facilities for insuring genuineness are apparent. The main source of difficulty has arisen from the fact that the cotton bills now usually pass through New York banks, which obviously do not have the means of verifying the

bills of lading, as do the banks in the cotton district. The attempt of the English bankers to force the responsibility home upon the New York bankers has its origin in the same general cause. Were cotton bills generally accepted by Southern banks, the risk would be placed where there is the least chance of deceit, *i. e.*, on the acceptng banks. If desired, the American banker could insist upon holding the bill of lading until the cotton arrived at destination, and requiring that it should be placed in the warehouse, insured for his benefit, and paid for only when withdrawn from the warehouse by the mill. Such a procedure is usual in handling imports, such as coffee. Such a method could be successfully carried out by Southern banks, and they could transact a very much larger business than now, were there established a National Reserve Association at which an accepting bank could rediscount its own acceptances; or if there existed a general discount market for acceptances.

§7. Lastly, we may briefly discuss (b) the relation of the financing of imports to the National Reserve Association.

Financing of Imports

A in New Orleans purchases coffee ($10,000) from B in Rio Janeiro. A wishes a time loan on this coffee in order to be able in due course to pay for it out of the proceeds of its sale. A applies to Bank X in New Orleans for a credit in London, which he can transfer to B's order; because, as Brazil buys its goods in Europe rather than in the United States, it wishes to use its proceeds from exports of coffee to the United States in payment of its debts to Europe. Bank X grants this loan to A by instructing its correspondent bank, Y, in London to accept drafts (or bills of exchange), usually running ninety days ahead, drawn by B in Rio Janeiro on London to the amount of $10,000. Bank X guarantees to Y the payment at maturity of this draft. The charge for this credit to A is made in the form of a commission of ½ of 1% ($50), of which ¼ of 1% ($25) goes to the London bank, Y.

The London bank, Y, receives the draft from B in Rio accompanied by the Bills of Lading and the Insurance Certificates of the coffee sent to A in New Orleans. Bank Y accepts the draft, but sends the bills of lading, etc., to its correspondent, X, in New Orleans. Then A must pay Bank X for the coffee: either (1) in cash, less the discount at the London rate to date of maturity; or (2) A may leave the documents with Bank X until the coffee ar-

rives; or (3) A may take the coffee out on a Trust Receipt, place the coffee in a warehouse, and give Bank X the warehouse receipts as security; or (4) A may be given the coffee on Trust Receipt, and allowed to sell it, the bank arranging to be paid by A fifteen days before maturity of the bill in London. Thus A expects to get the means of payment for the loan by a credit based on the sale of the coffee.

Direct Connections With Foreign Banks

If acceptances by national banks were legalized under the National Reserve Association act, a national bank, X, could itself accept these drafts from Rio directly, without asking London to do it. This paper would have on it the name of the Brazilian exporting house, and of Bank X which accepted it, and it would be guaranteed, also, by the importer, A, in New Orleans. If Bank X accepted the Rio draft, Bank X could provide A with a bill of exchange on London which A could transmit to Rio in payment of the coffee. Then from the proceeds of the sale of the coffee A could pay off his obligation to Bank X. As is well known, such a use of credit instruments would prevent the needless shipment of actual cash. By this method the profits of accepting bills would be transferred from London to New Orleans. Of course, any state bank or trust company, not being under the jurisdiction of the National Banking Act, could do this business to-day; and it is coming to be understood by some enterprising state bankers in the South.

The outcome of the whole matter is that the National Reserve Association would by evolution carry to a wider field of operation the principles of the clearing house associations, and save the needless movement of actual cash, not merely between banks in the same city, but between different portions of the country. Thus the crop-moving period would no longer be a time of a great shifting of money reserves, and a time of stringency, but a season of prosperity and increased purchasing power.

CHAPTER XX

THE DEPOSITOR

1. Relation of the Depositor to the Bank—2. Guarantee of Deposits—3. Shortcomings of Examination—4. Bank Failures—5. The Question of Rediscounts—6. Segregation of Commercial and Other Banks.

§1. The relation of the depositor to the bank is often spoken of as if it were the principal problem to be dealt with from the side of the public in relation to banking. In former chapters, we have seen that the same point of view is also taken with respect to the note-holder. Neither view, in this exclusive form, is well founded. Both the note-holder and the depositor must be considered since both are holders of demand liabilities of the bank. But, while both are theoretically to be regarded as equal, the fact remains that in modern banking in commercial countries, the depositor has gradually assumed a much more important place than the note-holder because of the fact that the deposits which the bank has obligated itself to pay are so much larger than the notes which it has issued and which it has undertaken to redeem.

Both Depositors and Note-holders Must Be Considered

A completely erroneous view of the depositor and his status is often taken and until this is eliminated, nothing can be accomplished in analyzing his relation to the bank from a correct standpoint. The ordinary discussion of the depositor assumes that he has left something with the bank for safekeeping. This the bank is assumed to have received, and to be protecting, using it in the meanwhile for its own purposes as it is permitted to do. What the depositor is thus supposed to have "left" is "money." The bank is conceived of as the guardian of the depositor's money and he is thought of as having placed money in the bank. This is practically the reverse of the case.

Erroneous View of the Depositor

It is true that a few depositors bring actual money to the bank and leave it there, receiving in exchange a credit on the books of the bank, which is evidenced by a memorandum or by figures in a so-called "bank book." But this is not the way in which the bulk of

the deposits are made. Usually the deposit is made by asking the bank for a loan. A borrower goes to the bank and offers his note, with or without some additional protection. The bank agrees to grant him the desired accommodation and he gets a credit of, say, $1,000 on the books. Against this he is allowed to draw; and, if he wishes, he may call for cash to that amount. The depositor who has actually left cash with the bank could not do more. Both are depositors upon an equal basis and are treated alike by the bank. In fact, neither of them usually wishes to draw any money except, perhaps, in relatively small sums for current use. If they did so desire, they would not have become depositors at the bank in the first instance. The man who actually left cash there would not have done so but would have kept the cash in his possession. The man who got the loan would have taken it in the form of notes instead of that of a book credit.

Depositor Primarily a Borrower

This gives us a new point of view as to the depositor. If he is not, in the majority of cases, one who has left money with the bank, but is one who has obtained a loan from the bank, what is the relation of the bank to him, and what ought to be the things or conditions which he should be in position to exact from the bank? What ought the institution to be expected to do for him?

These questions can be tentatively answered by considering what it is that the bank agrees to do when it either accepts his money on deposit or grants him a credit on its books. The thing it undertakes to do is to liquidate, in current funds, all claims that may be presented to it up to the amount thus credited, redeeming them in cash over the counter if actually called upon to do so. Of course, as everybody knows, no bank could redeem its outstanding deposits in cash if all depositors were to call upon it at once to make good their claims in that way. It is assumed that they will not do so, but that only a normal amount of them will come in. If the bank keeps itself in such condition that it can meet the normal claims of depositors that are regularly presented to it, and maintains its assets in such condition that with a reasonable and average notice it can convert them into cash and thus ultimately liquidate the whole of its depositors' claims upon it, it has done all that can properly be expected. Discussion of the relation of the depositor to the bank must therefore be an analysis of the way in which the bank has to proceed in order to get these results, and the nature of the precautions that must be observed in order that all

banks may have an equally favorable chance of success in thus protecting themselves and their creditors.

§2. It is to be noted that in the foregoing analysis nothing has been said of "guarantee of bank deposits." In recent years there has been an outcry for legislation that would guarantee the depositor against loss through the failure of banks and would also guarantee him an immediate payment in the case of suspension. This notion was based upon the idea that the deposits in banks were actual deposits of money and as such that their "return" could be "guaranteed." It was supposed that by establishing a "guaranty fund" contributed to by all banks in a certain percentage of their outstanding deposits, a resource would be created upon which all claims payable by failed or suspended banks could be made to draw.

Demand for Guarantee of Deposits

The trouble with this supposition was that (as we have seen) the deposits were credits in the proper sense of the term and the guarantee of bank deposits was therefore a guaranty of bank credits or, in other words, a guaranty on the part of banks that the loans they had all made would be liquidated at once if desired. Inasmuch as bank deposits are several times the amount of cash in existence at any given moment, and inasmuch as values depend entirely upon the continued existence of business as a going operation, the guaranty thus offered was impossible and imaginary. There was no assurance that the claims could be liquidated at any given moment and could not have been, since no one could know how many would be presented at any given time. Wherever the bank deposit guaranty system has been tried, it has been found ineffective.

Based on Mistaken Conception of Deposits

The real nature of the guaranty which can and should be given to the depositors of the bank is not found in the furnishing of an assurance that the deposit accounts will certainly be paid. That merely prevents depositors from discriminating between banks and selecting their institutions wisely and carefully. It is found in the establishment of regulations which will give all the assurance that is humanly possible that banks are being carried on efficiently and safely, that their funds are being invested in properly secured loans, and that they are maintaining a due degree of liquidity in their assets.

An Efficient Guaranty

Part of this kind of assurance can be had from thorough and careful inspection of banks and the rigid enforcement of restrictions upon bank business which will prevent the institutions from en-

gaging in hazardous or doubtful operations. If banks can be prevented from using their funds in directions which would not be approved by stockholders and creditors, all has been done that the government is in position to do, and there is no ground for demanding that other banks stand behind the credits granted by the institution to depositors. If to this be added such arrangements as will insure the banks a means of liquidating their paper at those times when they desire to convert their assets into immediate funds, there is little more that can be done.

It has been supposed that, under existing conditions in the national banking system, the government was performing the first of these duties, that of thoroughly inspecting and examining the banks, although it was not performing the second. Even if it were true that the duty of inspection and examination were being fully performed by the government with respect to the national banks, the question of the state institutions would still remain. It is a notorious fact that, although there are some states whose bank examinations are as good as or better than those of the national government, there are numerous others in which the examinations are unsatisfactory. Since the state institutions outnumber the national more than two to one, and since difficulty with banks in one system may communicate itself to the banks in the other, it would not be true that depositors were getting the proper protection today even if the national system of inspection and examination were sound or even if most of the systems of the states were also sound. But there is grave doubt as to whether even the national system of inspection is satisfactory.

§3. Within recent years a very serious defect in the national banking system has been found in the difficulty of examining the different institutions. During the earlier years of the system when the banks were few in number the problem of examination was not very serious. It was then possible to send satisfactory and capable examiners with sufficient frequency to the different banks, and to ascertain with substantial accuracy what they were doing. Many conditions intervened to change this situation. The very growth of the system has thrown serious obstacles in the way of examination. Obliged to follow reports from more than 7,300 national banks, the officers of the Currency Bureau in Washington find it far from easy to keep in mind the doings of each of the banks. But the growth of large systems of state banking and the development

Obstacles to Thorough Examination

of trust companies organized under state laws by the side of the national banking system has greatly complicated the problem.

Many of these state institutions are affiliated more or less closely with national banks, while many more depend on the national banks to hold their reserves and supply them with loans. The state institutions are subject to the oversight and control of the state superintendents or supervisors of banking. Although genuine efforts have been made by the Comptroller of the Currency to improve the examining methods of the national banks and to bring about coöperation and uniformity between the national and state systems, his efforts have been only partially successful. Until very recently, a bank which was driven out of the national system for loose or bad banking promptly took out a state charter; and *vice versa*. This meant that it was impossible to get rid of the undesirable banking institutions of the country since they could always find a refuge, even though they had been obliged to give up their original charters on account of bad or doubtful practices, or the making of unwise loans.

Interrelation of State and National Examinations

Under existing conditions, it is also very difficult to keep track of the paper which is outstanding and to make sure that it shall not be distributed by borrowers, who want more accommodation than they are entitled to, throughout a large group of banks none of whose members knows what the others are doing. The Comptroller of the Currency has done what he could to bring about a greater diffusion of knowledge of this kind among the national bank examiners, and through them among the banks themselves, but his efforts are, of course, confined to the system under his jurisdiction. He cannot know of the conditions existing in the state systems, except by the courtesy or aid of state bank examiners, which they are not obliged to extend. It is, therefore, entirely possible to float paper in the ways indicated, and thereby to secure extensions of credit that ought not to be granted. Secretiveness and hostility among many of the banks greatly promote this condition of affairs, and it could be remedied only by some measure that would unite the banks more truly than now into a system, in the proper sense of the word. Until that shall be done, it will unavoidably be true that, owing to lack of knowledge and inadequate facilities for testing paper, the banks will suffer to a certain extent, and the soundness of the situation will be correspondingly impaired.

This condition is seen at its worst during a period of credit inflation. In such a period, banks, perhaps throughout a given sec-

tion of the country, become over-confident and extend loans on certain classes of security either directly or indirectly beyond the limit to which they ought to confine themselves. Having thus exceeded the bounds of caution, there is nothing to check them such as would be supplied by a coöperative association to which paper would be carried for rediscount. Banks at a distance rediscount freely for the institutions which have been doing business with them in the speculative region, while other banks rediscount in the same way for still other institutions in this same area. That is, as things stand today, the capital of conservative districts is used to facilitate loans in speculative districts.

In consequence, credit is extended for certain purposes in a way that would not be followed if there were any general method of checking up what has been done. With the existence of such a method, there would be furnished a means of accurately estimating the total amount of the available funds of the country which were being employed in certain classes of undertakings. Both the banks which originally made the paper, and those to whom it might be presented for rediscount, would thus get a far clearer knowledge than is possible at the present time. Present bank examinations cannot thoroughly reveal a condition of this sort because they afford no comparative test, or attempt such a test only in a remote and approximate manner. It is entirely possible that the assets of a bank at any given time may be quite sound, considered by themselves, yet be far from sound when considered comparatively with those of other institutions. Such a comparison reveals the fact that there has been undue emphasis upon certain classes of loans so that the liquidity of the paper is seriously impaired. This merely presents one phase of the danger that exists in an incompletely organized banking system, of diverting capital too largely into given channels and occasionally of making too largely extended loans upon given kinds of security. It is not a situation that can be corrected by any examination plan *per se,* however thorough.

Difficulties Increased in Time of Inflation

§4. It is a natural consequence of our incomplete and inadequate system of examination that there should be a good many bank failures from time to time. The statement is frequently made that such failures are not very numerous and that there is no particular reason for fearing failures under the national system unless there has been dishonesty on the part of officers. The

Failures of National Banks

facts hardly bear out this assertion. According to the report of the Comptroller of the Currency for 1910, such failures have caused a loss of $150,000,000 and have been as follows:

Summary of Reports of Receivers of Insolvent National Banks, 1865 to October 31, 1910.

	Closed receiverships, 459	Active receiverships, 55	Total, 514
Total assets taken charge of by receivers	$296,406,777	$45,399,194	$341,805,971
Disposition of assets:			
Offsets allowed and settled	23,696,964	3,417,858	27,114,822
Loss on assets, compounded or sold under order of court	107,773,294	4,448,160	112,221,454
Nominal value of assets returned to stockholders	14,045,068	.....	14,045,068
Nominal value of remaining assets	3,714,802	14,734,104	18,448,906
Collected from assets	147,176,649	22,799,072	169,975,721
Total	$296,406,777	$45,399,194	$341,805,971
Collected from assets as above	147,176,649	22,799,072	169,975,721
Collected from assessments upon shareholders	19,498,142	2,089,868	21,588,010
Total collections	$166,674,791	$24,888,940	$191,563,731

While it is true that the number of failures thus reported does not appear to be very great when considered in the aggregate, it is much greater than the failures reported from other countries. The total number of banks failing in Canada during the past twenty-two years was only six, with a total amount of capital of less than $2,000,000. Their liabilities were about $12,571,000, most of which were paid. This was the experience under a competitive banking system, which numbered in 1909 some thirty-three banks, with a joint capital of $143,466,000. The losses in other countries have been even smaller, depending upon the degree of oversight and closeness of supervision accorded to the banks. Nowhere has a system of banks directly overseen and controlled by the governments of European countries proved itself liable to failure.

Failures in Other Countries

It is thus evident that while the national banking system has not been peculiarly subject to insolvency, considering the great number of small units of which it is composed, it has, nevertheless, been far from affording complete protection to its creditors. The losses to stockholders have, of course, been severe in those institutions where a receivership continued for some time or where assets were bad or doubtful to begin with. The fact often alluded to that no note-holder of any national bank has ever lost, owing to the fact that his notes are protected by

government bonds, which the bank is compelled to buy in a specified percentage upon organization, is not a very important point. Clearly the benefit or gain to the note-holder thus secured is offset by a corresponding decrease in the assets which might have been distributed among the other creditors.

On account of the necessity of going through the legislation and regulations of so many different commonwealths, it would require a much more elaborate treatment to show how inspection and examination work in the several states and what are the defects of these local systems, but it may be stated with truth that the evils present in the national system exist throughout the state systems, and in a magnified form. The state systems have been thoroughly unsatisfactory in the matter of failures, while in so far as concerns examinations, most states leave a great deal to be desired. All this urgently raises the question, What can be done to improve the situation regarding the safety and solvency of the banks of the country and thereby to put the depositor in the proper position with respect to the bank, the position to which his claims indisputably entitle him?

State Systems Unsatisfactory

Evidently the first step to be taken in this direction will be that of making all banks engaged in regular commercial operations as nearly subject to one general kind of oversight or control as may be. This could hardly be done by any direct legislation under our constitutional system. But it can be reached by some action that will unite the banks into a coöperative association for the purpose of supplying one another with funds through a rediscount process whenever that may be found necessary. If a reserve association, such as has been suggested in preceding chapters of this volume, were to be created, the effect would be to cause many banks to resort to it for accommodation as their needs might dictate. Probably every bank that owns stock in the association would at some time or other obtain loans from it, while those that did not do so would undoubtedly keep their spare funds with it on deposit.

Advantage of Concentration of Supervision

The result of establishing such an association, with its various branch offices, would be to create a general standard as to banking operations and to enforce this standard in a way that is not now possible. Banks would seek, in the first place, to confine themselves to such business as was recognized by the association as legitimate, and would attempt to have on hand at all times a fair amount of paper of the kinds that could be rediscounted with the

association. The effect of this would be to exert the same kind of wholesome influence that is now exerted by clearing-houses in the large cities. Such influence, however, would be extended to the smaller towns and villages, and there would be a general toning up of the banking system throughout the country. Bank paper would be standardized and bank operations subjected to a uniform mode of control.

In these ways, depositors would be very greatly protected. They would run no such risk as they now run through the resort by banks to irregular methods of doing business, since it would be far easier to detect such methods under the proposed system. A genuine "guaranty" of bank deposits in the best sense of the term would thus be afforded, because the depositor would get the kind of protection he required, and the institution with which he dealt would be likely to fail only as the result of direct dishonesty on the part of officers or directors.

§5. While what has been said holds good of the banking system and of banking operations generally, there remains the question of the relation of the bank to the depositor in times of panic. It is this, and not the relation of the bank to the depositor in ordinary times, that has received most attention, notwithstanding the latter is probably the more important problem of the two.

Demand for Cash In Time of Panic

What happens in periods of panic, as we have previously set forth, is a sudden call on the part of depositors for the liquidation of the bank's obligation to them in spot cash. As we have seen also, this is not a demand that is likely to be made by depositors everywhere, or even at very many places. If it were, no means of meeting the demand could be devised. The demand occurs only at certain banks and in certain places, and the sole question in such cases is whether these banks have good assets. If they have, depositors should not be obliged to go without their funds, but should be enabled to get cash if they wanted it.

This can be accomplished by means of a rediscount institution which would enable such banks to convert their assets into immediate means of payment. Such an institution would be provided in the proposed Reserve Association; and, if it were, the change in the present situation would simply amount to an assurance to all depositors that whenever the banks with

which they dealt had good assets, they need feel no doubt whatever about their own capacity to secure cash at any time they desired it. The bank which held their accounts would be able to go to the Reserve Association, ask for a credit there, presenting its commercial paper of specified kinds for rediscount, and then either to use this credit as a reserve (thereby releasing the actual funds held in its vaults), or take it in notes of the Reserve Association which could be paid out over the counter, thereby substituting the note liability of all of the banks of the country (as federated together in the Reserve Association), for the obligation of the local bank itself, which for some reason had incurred the distrust of the depositors. The operation would be exactly the same that is performed by our clearing-house associations when they issue clearing-house certificates, except that it would be managed smoothly and efficiently, without any of the shocks to business confidence which are inevitably given under present methods.

Met by a Rediscount Institution

It can safely be asserted that, with such a system in working order, funds would seldom be called for. They would never be asked for by depositors of banks which were recognized as undoubtedly keeping their funds in an available form through the maintenance of a volume of paper that was eligible for rediscount at the National Reserve Association. Doubtless, many small depositors would know nothing of the practices of the banks in this regard. Large depositors would have this knowledge, however, and would act accordingly. If small depositors, owing to some false rumor or market flurry, should lose confidence in a given bank and begin to draw out cash, it would be easy to check them promptly by obtaining abundant rediscounts from the National Reserve Association, and allowing the fact, if necessary, to be known. The consequence would be that large withdrawals of cash by depositors at times of panic or doubt would not take place, and the whole system would be put upon a much more satisfactory and normal basis than it is at present.

Reserve Association Would Prevent Call for Funds

As we have seen, this would save an immense amount of waste in the use of reserve money by avoiding the maintenance of great sums of cash in the vaults of banks. It would also avoid the current necessity of obtaining actual cash and paying it out over the counter in those instances where a run occurred. An issue of notes by the Reserve Association would avoid this necessity, while the notes would be equally acceptable to the depositors as cash, since they could use them for practically

Saving Thus Effected

every purpose for which cash could be used. The conveniences of the banks and of the depositors, economy of the country's money supply, and avoidance of unnecessary strain on bank reserves would result from this method of meeting the calls of depositors and the latter would be correspondingly aided.

While this condition of affairs is sometimes spoken of as being of great advantage to the banks, inasmuch as they would be protected against disturbance to business, loss of reserves, etc., the protection and advantage to the depositor would be vastly greater than to the banks themselves. Depositors who call for cash in times of loss of confidence do so, not because they want the cash, but because they have come to fear that the institution which is holding their deposits is not capable of maintaining payment. They recognize the serious loss to which they will be subject, if, as a result of the bank's suspension, they are prevented from drawing their funds as they need them. This loss is not merely the ultimate sacrifice of the value represented by the depositor. On the contrary, an analysis of bank failures shows that, in the long run, a very large percentage of bank obligations is fully liquidated, when the banks have had the time they need to convert their assets into cash and call in the proceeds of stockholders' liability, etc. Meantime, however, the immediate need of the depositor has not been met. His funds being tied up, he has been unable to meet claims upon him, or to take advantage of business opportunities, or perhaps to liquidate pressing indebtedness, failure to meet which means loss of business credit and possibly, in extreme cases, bankruptcy. The return of his funds at some period far in the future is not a sufficient recompense to him.

Rediscount Market Protects Depositors

Guaranty of bank deposits, even if it succeeded ultimately in making good to every bank depositor the total amount that was due him from banks, would not suffice to meet the real needs of the situation, since the most important requirement is not ultimate but immediate payment; and the latter, as we have seen, none of the familiar deposit guaranty systems can provide for. They would break down as soon as the immediate liability became large, and at best could merely succeed in subtracting some cash from the other banks, thereby weakening them to a corresponding extent without, as a rule, doing any good to the depositors. But by giving to every bank the power to convert its reliable assets into cash by rediscounting them as may be desired, the requirements of the depositor for immediate payment are fully protected up to the point

Guaranty of Deposits Does Not Meet Real Needs

that the bank with which he deals is in possession of good bankable assets which it can with assurance present to the Reserve Association for rediscount.

Besides aiding the bank, the establishment of a discount market furnishes an accurate measure of the depositor's responsibility. Such responsibility is destroyed under a bank deposit guarantee system. As against that system, the proposed plan requires the depositor practically to keep his funds with those banks that confine themselves to strictly commercial banking, if his own business is such that his prime need is constant ability to draw. If a depositor found that his bank, in a time of stress, was not able to meet his needs and could not liquidate the deposit accounts it had become liable for, he could only conclude that the kinds of loans it had made were predominantly those which gave rise to paper which the Reserve Association could not recognize. It would then be for him to choose whether he would continue to do business with an institution that accepted such business as thus referred to. He might conclude that it was preferable to keep his account with a bank that loaned only on commercial paper of the highest type. Probably this would be his conclusion if that were the type of paper that was produced by his own operations. Of course, if the loans he himself had obtained were based upon security, which, although perhaps perfectly unimpeachable, was of a kind not recognized by the Reserve Association as furnishing a proper basis for loans, he might prefer to continue transacting business with an institution which engaged in operations not of the strictly commercial banking class.

Rediscount System Makes Depositor Distinguish Between Banks

In this way a fairly sharp segregation of banks doing a commercial business, and of banks engaging in other operations, would be brought about. There is a strong tendency toward such segregation today, as we have seen elsewhere, but this tendency would be very greatly strengthened and increased by the sharp distinction that would be drawn (under a discount system which was ready to grant accommodation to banks presenting short-time live commercial paper) between banks which could and those which could not offer security of this kind.

Promotes Segregation of Commercial Banks

§6. It should not be understood that such segregation would imply an inability on the part of banks doing a non-commercial business to get accommodation in case they were hard pressed. The savings bank which was being drawn upon by its depositors,

the trust company which found its deposits leaking away, and other institutions in difficulties, owing to the urgent nature of the demands made upon them, would always be able to request other banks to grant them assistance with as good a prospect of being listened to as their securities warranted, and their depositors would benefit accordingly. The extension of such accommodation would, of course, depend upon the condition of the other banks of whom the request was made, and the arrangements that had been made with them beforehand, but their capacity to aid would be greatly strengthened by the creation of a discount market.

Would Not Deprive Non-Commercial Banks of Aid in Need

It is a fact that in European countries today there are many such banks which succeed in getting abundant accommodation from other institutions when they need it. They very seldom suspend or fail as compared with banks in the United States.

But the distinct recognition of two classes of banks, one dealing predominantly in live commercial paper and confidently looking to a coöperative association comprising the banking power of the country for aid when needed, the other making loans of a less stereotyped character and getting assistance only in proportion as that might be granted by other banks of the community, places the depositors in a very much stronger position. They are able to select the banks with which they are to do business, with far greater discrimination and intelligence. A savings depositor, for example, who does not need his funds currently, but who merely wishes to be certain of their ultimate return, is safe in leaving his funds with a savings bank, although he knows that this bank may, if hard pressed for funds, require a notice of sixty days before he draws any cash. On the other hand, the holder of a trust fund may prefer to deposit this fund with a perfectly solvent trust company which will pay him a rate of interest, even though it would not be possible for him to draw the cash at any moment in case of stringency. This may be due to the fact that he would rather get the interest than be able to draw his money certainly on demand. At the present time, these functions are far too greatly confused, many banks having both savings and trust deposits as well as their regular commercial deposits growing out of loan and discount operations. The distinct segregation of the banks by classes aids materially, not only in rendering possible an effective system for keeping commercial discounts liquid, but in enabling depositors to make definite choice of an institution whose business practices are suited to their special or peculiar needs, and then to exact from it the proper methods of operation.

Segregation Protects Depositors

CHAPTER XXI

THE RESERVE ASSOCIATION AS FISCAL AGENT OF THE FEDERAL GOVERNMENT

1. Banks as Government Depositories and Establishment of the Independent Treasury System—2. Workings of the System—3. Exchange Functions of the Treasury—4. Foreign Experience—5. Plan of National Reserve Association—6. Contrast With Present System—7. The Question of Safety of the Government Funds—8. Public Function of National Reserve Association.

§1. An integral part of the proposed plan of banking reform is found in the transfer of government funds from the Treasury of the United States to the banks of the country. The depositing of public funds in banks was the policy of the United States government from the adoption of the Constitution down to 1846 when the present independent Treasury system was created. Shortly after the adoption of the Constitution, Alexander Hamilton, then Secretary of the Treasury, recommended the establishment of a large institution to be known as the Bank of the United States. This was finally chartered in 1791 with a twenty-year franchise. From 1811 to 1817 public funds were deposited in private banks. Then the second Bank of the United States was chartered and it continued in operation until 1837, when it went out of existence, and public funds were again deposited in the state banks. This plan continued to be followed until 1846, as already noted.

Government Depositories Before 1846

While the first and second United States Banks were, in the main, ably conducted, and were at all times sound financial institutions, handling the funds of the government with economy and despatch, there was much complaint of their operations on the ground that they were influenced by political considerations. On the other hand, the placing of public funds in state banks was not satisfactory, because these institutions were small and often inefficient. Frequently they suspended payment or failed, and as a result the government was either kept from the use of its funds for a long time or unable to get them back at all.

The consequence was the adoption of a plan whereby payments and disbursements were to be made in actual money, and whereby the government was to keep its funds in its own vaults. To this end so-called sub-treasuries were established at convenient points in which the receiving officers of the Government were directed to deposit the funds coming into their hands and for which disbursing officers were supplied with funds through properly drawn warrants.

The Independent Treasury System

§2. A rigid adherence to the notion of having all payments and disbursements made in money has not been possible, and to-day various modifications of it are in effect. Perhaps the most important is that which permits the Government to deposit Treasury funds with national banks on condition that these banks shall turn over to the Government approved bonds to an amount equal to the sum of deposits left with them. In this way it has sometimes occurred in recent years that all of the available funds of the Government except a small working balance were parcelled out among banks. There have been times when the amount thus distributed was as much as $250,000,000 and the number of depositary banks nearly 1,400.

Modifications of the System

Moreover, it has not been found possible to keep the Government entirely separate from the machinery of modern banking. Today the independent Treasury System consists of the Treasury itself, and nine independent or sub-treasuries located at as many different places. These sub-treasuries are members of the local clearinghouses in the places where they are situated and clear their claims with the banks through this means. When it has debts to pay, the Treasury pays them by means of a Government warrant (the equivalent of a check, which it resembles in form), upon a convenient sub-treasury. Such warrants are deposited with the banks by the persons who receive them and thus the banks come into possession of claims against the sub-treasury. On the other hand, the Government at times finds it desirable to draw on the depositary banks, and thus the banks and the sub-treasuries have occasion to interchange their claims by the usual clearing process.

Essential Features Remain

But in spite of these modifications in the system, its essential features remain. It is substantially a plan for drawing the funds of the community by taxation out of the pockets of the people, keeping them locked up for an indefinite period in government

vaults, and finally paying them out in whole or in part to other persons. This set of operations has a serious and important effect upon the business of the community.

§3. On account of its possession of large quantities of cash funds and its refusal to let these funds go back into circulation, the Treasury Department has been forced to accept still other banking functions. It now supplies exchange at current rates by allowing sub-treasuries in the various places to pay out cash upon telegraphic order when an equal amount of funds plus exchange has been deposited elsewhere. Thus payments at New York may be offset by disbursements at San Francisco, if New York banks desire to supply currency to others in the latter city.

The function of providing exchange in this way is not properly a governmental duty but should be exercised in conjunction with the function of discounting and of buying commercial paper. When divorced from the latter function, it tends to disturb the exchange market, although it may serve a useful purpose at the time it is performed by obviating the necessity for shipments of currency back and forth. The same end would be gained, and gained much better, if the funds upon which the Treasury bases its operations were in actual commercial use the country over. Yet how can this end be attained, and the exchange function be entirely relegated to the banks, so long as the government is the holder of so large a percentage of the country's circulating medium? It is not possible to turn this work over to the banks while the funds of the country are partly in the Treasury; nor would it be practicable to entrust them with the work of supplying exchange in this way without giving the profits to a relatively small number of them.

Domestic Exchange Not a Government Function

The problem raised by the independent Treasury system is therefore not only that of meeting the demand for a better disposition of the actual funds of the country, but is that of affording some means whereby the public may get the benefit of the banking mechanism, operating upon these funds in connection with its commercial transactions. This merely amounts to the statement that the essention evil in the independent Treasury system today is its withdrawal of current funds from banking uses and its consequent infringement of the functions which are, and can be, successfully performed only by the banks. This may be re-stated by saying that the United States Treasury is not a bank and cannot successfully

Independent Treasury Withdraws Funds from Business

perform the services which banks render, yet that it takes to itself the funds of the community without giving any return in the form of aid to exchange and business.

Our System Unique

§4. The facts which have thus been briefly stated are so well understood throughout the world that the independent Treasury system is today almost if not wholly unique. No important country today hoards money or currency or declines to accept the properly authenticated checks and notes of solvent banks in liquidation of claims due to it. Nor is there any which fails to employ the solvent banks of the country and their credit mechanism in making its payments to individuals, corporations, and other countries.

In most European countries today, there is a close official relationship between the financial department of the government and some great banking institution. Familiar examples of this kind are seen in the case of the Banks of England and France, and of the Reichsbank of Germany. These great banks hold the funds belonging to the public and in return are closely supervised, inspected and controlled by the governments with which they are affiliated.

The fact that government funds constitute everywhere so large a sum and could be used for the purpose of earning an enormous profit were they freely entrusted to the banks in which they are deposited, has led to the adoption of methods for assuring to the public powers their due share of the profits which may be obtained in this way. Various ideas have existed with reference to the best method for reserving to the government its proper share of the proceeds of the banking business under such conditions. In the first and second United States Banks, the government of the United States, which had chartered the institutions, was a large stockholder, and received the dividends upon its stock as did other owners of shares. In Germany at the present time the government obtains its share of the proceeds partly by means of taxation and partly by a division of profits. In France a similar system though with different details is adopted. The general opinion in the advanced commercial countries of the world is that, while it is absolutely essential that some institution shall act as a connecting link between the government and the financial system of the country, it is necessary that the profits derived incidentally in this way shall go in large measure to the government. Probably the best opinion

Distribution of Profits from Use of Public Funds

at present supports a plan whereby all income above a mere commercial rate of interest on the capital invested is taken by the government in return for its grant of a franchise to the institution which holds its cash, as well as for the advantage given by the use of the immense deposits of current funds made by the government itself.

§5. This is the arrangement which is aimed at in the National Reserve Association proposal. It recognizes the essential necessity of leaving the funds of the country in the hands of the community and of reserving to the government the profit which would come from their use by a private agency. It contemplates placing in the hands of the Reserve Association, as that institution has been described, all of the current funds of the Treasury. It is intended that the government shall regularly place its receipts on deposit with the Association except in those cases where it may be desired to put funds into national banks in cities where no branch of the Reserve Association exists. Disbursements, however, would be made entirely through the National Reserve Association. It would be the duty of that association to make payments without charge at those points where the government had obligations to meet. The notes of the Reserve Association would be received at par in payment of all dues to the United States and would be payable by the United States to all of its creditors except those who held obligations specifically payable in gold.

Excess Profits to Go to Government

In return for this relationship to the government and the possible profit which might be made out of it, the Reserve Association would turn over to the government all earnings at the start in excess of 4 per cent. Of these earnings a division would be made, one-half going to surplus of the Reserve Association until that surplus amounted to 20 per cent of the paid-in capital, and one-fourth to stockholders, while one-fourth would go to the government. When the stockholders' dividends reached 5 per cent and when the surplus of the Reserve Association had reached 20 per cent of its capital, the whole balance would be given to the government. This would mean that, however large the earnings made by the use of the government's funds might be, they would revert to the government after the stockholders had received a moderate interest of 5 per cent on their investment. At the present time the average earning upon all capital invested in national banks is very

nearly 10 per cent. Besides getting whatever profits were thus earned from the use of its funds, the government would make a large saving in running expenses. It would no longer have to manage exchanges, see to the transfor of funds hither and thither, and pay the charges arising out of these duties. The Reserve Association would do this work and would do it without charge.

Average Earnings on Bank Capital

In our earlier discussion we saw that the fundamental question to be considered in connection with national banking was the effect of any change that might be introduced upon the reserve system of the national banks. This was because the reserves are the fundamental element in the banking system and upon them depend the solvency, economy and efficiency of the whole. It is important, therefore, to consider first of all what would be the change in our reserve system arising from the designation of the proposed National Reserve Association as the fiscal agent of the government.

The effect of the change can be briefly stated. It would abolish all of the artificial disturbances which arise from the present Treasury system, and would leave business conditions and relationships practically the same as they would be, from the banking standpoint, if the government never exacted any taxation. When taxes were payable, when customs duties were collectible, they would be paid to the government either in notes of the National Reserve Association or in checks upon it, or, of course, if the payer wished, in actual money.

Effect on Our Reserve System

Suppose the case of an importer at New York who had a large consignment of goods which he wished released from the custom house. If his customs payment was $20,000 and if he did not wish (as he would not) to make payment in actual money, he would go to his own bank and would obtain from it a draft on the National Reserve Association, or, if he desired, notes of the National Reserve Association. He might pay for this draft or the notes in a check drawn upon a previously established credit in the bank itself, just as today, if he wished to buy a draft on Chicago or San Francisco, he would get it from his bank and pay that bank with a check on itself. If his account with the bank was not large enough, he would have to obtain from it a discount, the bank placing to his credit such a sum as he desired and thus enabling him to buy from it a draft on the National Reserve Association. Of course the effect of issuing such drafts would be to reduce the bank's bal-

Illustrated by Case of New York Importer

ance with the Reserve Association. This would be built up again either by the depositing of claims on the Reserve Association transferred to it by other banks or by rediscounting, perhaps, the very paper left with the bank by the importer. In any case—and this is the important point—there would be no displacement of current funds. No money would have had to be drawn from bank vaults in making the payment.

§6. This transaction should be studied in comparison with the management of a similar transaction under the present system. Suppose that this importer today wishes to pay $20,000 in duties. Knowing that the payment is to be made, he has usually spoken to his bank in advance and the bank has sent to the sub-treasury gold or legal tender money to the amount of $20,000. Then when the importer appears, he is allowed to pay the government in a check on his own bank, because that bank has the actual cash in the vaults of the government. Or the importer may draw actual money from his bank and physically carry it to the sub-treasury, depositing it there at the time when he liquidates his customs duties.

What is the effect of either of these transactions? In the first place, the withdrawal of the money from the reserve of the bank means that so long as the funds are taken out, that particular bank finds its reserve weakened to a corresponding extent. If these funds went promptly into some other bank, little harm perhaps would be done, although even in that case, the effect of the transaction would be to withdraw the funds temporarily from the banks while the transfer was being made. It would be better even in such a case to have the payment made in the form of a check or draft which would stand a chance of being offset against other checks or drafts, so that only a small balance in money would have to pass in order to settle the transaction in the last analysis. But the sum withdrawn does not go into the vaults of other banks at the time. It goes into the Treasury, and must therefore be considered lost to the banks of the country so long as it is tied up there.

Weakening of Reserves

Will not the Treasury let the cash out almost immediately and will not the withdrawal therefore be only temporary? This depends upon the state of government revenues. Evidently, in order to have such an adjustment as would thus be produced, it is neces-

Treasury Hoards Cash

sary that (1) disbursements shall be made by the Treasury about as fast as incomes accrue, and (2) they shall be made at about the same places as those at which incomes are received. Neither of these conditions exists.

At present there is a very great difference between the rate at which funds come in and that at which they go out. Often for a series of years there is a regular Treasury surplus of incomes over expenditures. Funds come in much faster than they are spent. Even in years when the total outgo is about the same as the total income, that is not true throughout the year. Funds will be received largely at certain seasons and will lie idle for some months, when they will rapidly go out again.

Distribution not According to Needs

Moreover, the points where cash is disbursed are quite different from those where it is received. The government now gets its income chiefly at a few large ports through which goods pass into the country, and at a few points in the interior where whisky and tobacco taxes are paid. The corporation tax and a few other kinds of payment are more widely diffused, but they are minor items. The payments of the government are made largely at Washington, at those points where bodies of troops and ships of war are stationed, at the post offices and other government offices throughout the country, and at points where supplies have been purchased. In making payments, as we have already seen, the Treasury may either pay cash or issue warrants on the sub-treasuries. Whichever it does, the effect of its disbursements is to draw cash from the points of collection to the points of disbursement. If the payment were made in a claim upon such an institution as the National Reserve Association, this would not be the case, but the claim would go through the ordinary mechanism of banking, would be offset against other claims, and would in the long run give rise only to such a movement of cash as might be necessary to settle balances between different places.

Consequences of Hoarding

The present consequences of the Treasury system of hoarding are very serious. It is an unfortunate fact that the payments to the government under the present system of taxation are likely to be heaviest at those seasons when funds are most needed in reserve. We have seen in earlier chapters that the crop-moving season in the autumn is a period of special demand for accommodation. But that is also a time when payments for customs are likely to be heaviest. Throughout the late summer and early fall merchants are

receiving goods from abroad, releasing them from the custom house and paying duties. To do this they are withdrawing funds from banks and transferring them to the Treasury. Just at this same juncture, the banks are feeling the demand for large accommodations in the interior.

Of course the effect of thus diminishing reserves is to make it more expensive for producers to get accommodation, while the banks are embarrassed by the necessity of having to let go of the funds they need to sustain their credit. If it should happen that the surplus reserve of the country is very low at any time, the effect is to curtail the banks' power of lending very materially. There is no reason why government payments should be exceptionally large contemporaneously with these large receipts. In fact, they are not, for the greatest disbursements are made on the first of January and of July, when interest is paid, during the early months of the fiscal year, July and August, when new appropriations go into effect, and at other times of exceptional demand, due to payments for labor or supplies as determined by conditions of construction on public works and the like. The situation is therefore exceptionally embarrassing and difficult.

The Treasury has, as briefly noted heretofore, attempted to apply a crude means of relieving this situation. Whenever funds have tended to accumulate too rapidly, by virtue of its power under congressional enactment, it has redeposited with the banks. In so doing, it has, however, had to select the banks with which it would place its funds. Wisdom would have dictated the placing of the funds as near to the points from which they were drawn as possible. That would have been difficult at the best, but political exigencies have rendered it impossible.

Means of Relief Crude

Congress has made it mandatory upon the Treasury in making deposits to distribute them as nearly as possible in proportion to population throughout the states and territories. Unfortunately, the amount of business and credit performed and needed by different communities is not proportionate to population, and therefore the distribution has, in most cases, been productive of much incidental harm. It was much better to get the money out of the Treasury than to have it accumulate there, but it has never been distributed in such a way as to facilitate the needs of the country. Very often a large government deposit in

a town has resulted in the unwise extension of credit to enterprises which could not otherwise have obtained it. In other cases, when there was no local use for the funds, they have been shipped direct to New York, and have there been reloaned on call to speculators. It has been felt that, since the government might demand the deposits at an early date and since there was no profitable use for them at home, the bank might as well make the most out of them by lending them as a basis for speculation. Consequently, such deposits have not infrequently become a stimulus to speculation in securities.

Payment of Taxes Should not Disturb Money Market

The payment of taxes ought not to be an unnecessary disturbing influence to commerce. It should, in its essential nature, be nothing more than the transfer of a portion of private wealth to the public authorities. It should therefore cause no more disturbance than a similar transfer from one private individual to another. The transaction should be effected in the same way in which such transactions are effected in the commercial world. Whatever the ultimate economic result of taxation may be, there would then be no incidental effects. The operation of paying taxes would be merely that of establishing a suitable balance with the bank and then transferring the title to that balance to the government in the same way that the individual would pay any other claim upon him. At present this is not the case with federal taxation which, as we have seen, exerts a seriously annoying influence upon the mechanism of credit practically throughout the country.

With a proper banking system in close harmony with the public treasury, no such danger would exist, but the transfer would take place mechanically and the government would simply come into possession of a certain share of the wealth of the country as the result of its laws. So far as the banking mechanism is concerned, it would not matter whether this exaction were made at one time of the year or at another. Since no movement of money or currency would be necessary, no change would take place in the volume of reserve funds held by the institutions of the country, and no local readjustments in the supply of funds available at one point as contrasted with those available at another would be requisite.

While the effect of the substitution of the banks for the Treasury as a fiscal agent, through the medium of the Reserve

Association, would thus be desirable from the standpoint of taxation and of its effect upon the producing and exchanging mechanism of the country, the change would be equally as desirable from another standpoint. At present the Treasury Department exerts a disturbing influence upon the reserve supply of the country, not only through its receipts and disbursements of the proceeds of taxation, but through its handling of the public debt. The floating of bonds at the present time is effected by advertising for bids, which are subsequently opened in the Treasury Department, the bonds being then awarded to the highest bidder. Such bidders are usually banks and other financial institutions. With their bids they submit, as a rule, a certified check covering the percentage of their offering which is required by the department. Then, on getting an award, they pay in a certain percentage of the amount of bonds assigned them. Later they complete their payment by a specified date.

Handling of the Public Debt

The Treasury may either take the proceeds of its sales in cash or it may leave the funds on deposit with the banks, in which case it merely accepts a claim on the banks in liquidation of the loan. There have been occasions within the past ten years when the Secretary of the Treasury let it be known that he would leave the funds on deposit for a time with the same banks which received the awards of bonds, so that these banks would make payment to the Treasury merely by crediting the government with a certain sum on its books. This, however, is a rare case. Ordinarily, cash must be taken out of the vaults and turned over to the department, or else, even where funds are left on deposit, they must be shifted from the banks which get the bonds to the banks which are to receive the deposits. In either case there is a tendency to tie up the cash of the country and to place it in institutions remote from the points at which it originated. The harm is similar to that which was found to exist in the present method of paying taxes.

How It Would Be Managed by Reserve Association

It would be far better if the government obtained its payment for bonds in the form of a transfer to it of a credit on the books of a National Reserve Association representing the banks of the country acting as a unit. Then, if bank A, an institution of, say, $25,000 capital, at some point in the interior should bid for and secure a block of, say, $5,000 in government bonds, it could pay for these bonds by giving the government a check on the Na-

tional Reserve Association. This association would have granted to the bank the right to draw on it either in return for a deposit of cash, or a deposit of its own notes, or as the proceeds of a discount of commercial paper offered to it by the bank in question. Usually the interior bank would have built up its credit with the Reserve Association by offering such paper for rediscount. This would mean that there had been no disturbance of the reserve money of the country or of its distribution, but merely that the government had obtained a title to a certain amount of the fluid wealth of the country in exchange for its own long-time obligation. If it then paid out this wealth by giving to its creditors claims on the National Reserve Association, the whole transaction would have been settled by means of a mere transfer of title.

Suppose, for example, that the proceeds of the bonds were to be used in the irrigation of arid lands and that the government had a payment of $5,000 to make in the same general region, perhaps in the same county where the bank which got the bonds was located. In that case, the wealth would be expended in the same place where it originated. Not a dollar would have moved out of the community necessarily. The bank would have paid the government in a claim on the Reserve Association and the government would have paid the contractor in the same way. Very probably the contractor would have deposited the claim he received from the government in the bank which had bid for the bonds. Thus, in the last analysis, the bank would have obtained the bonds and turned over the payment for them to persons in the same community. If it had bought the bonds as agent of certain investors in the community, the investors would pay it by drawing checks in its favor on their bank accounts. The wealth of the country would have been invested to the extent of $5,000 in the irrigation system, and the local investors would have received bonds backed by the government to an equal amount.

Government Would No Longer Furnish Exchange

The task imposed on the government at the present time of furnishing exchange would be entirely eliminated by the use, as a fiscal agency, of a banking institution of the kind described. This institution, having close connections with banks in all parts of the country, would serve as a means for equalizing the supply of funds throughout the whole country, and would find the successful performance of this duty one of the chief tests of its efficiency and satisfactoriness.

Probably very much less demand for the movement of funds from one part of the country to another would be felt with such an institution at work than without it. It would tend to act as a great clearing-house for claims offered by one part of the country against another, and vice versa. When there was a demand for funds in one region, it would be met by the Reserve Association, which would create credits available there. These credits would later be canceled by others resulting from the sale of goods, and business would be financed without the movement of money. This alone would be a great saving to the community. It would also be a great saving to the government, which is not now able to take advantage, save in a minor degree, of the banking mechanism of the country, in facilitating its payments.

The Treasury would not only cease to furnish exchange for commercial applicants, but it would also cease to need exchange on its own account. Not only disturbance to business, but actual expense would thus be economized. It is impossible to say how large a saving in the routine operations of the Treasury could be made by the transfer of its funds to a fiscal agent in the way described, until details had been more fully worked out, but it is certain that the saving would be very substantial and that much work now done in the Department would be rendered entirely unnecessary.

§7. An objection which is frequently heard with reference to the adoption of this fiscal agency idea is that under it the government "would not be able to get its funds when it wanted them." This appears to mean either that the banks would be unable to pay on demand and would have to ask for time before meeting the request of the government, or else that there would be danger of failure. The latter question may be considered first.

Strength of Association that of Combined Banks of the Country

Certainly it would be an unfortunate situation if the proposed Reserve Association were to fail or suspend payment and thereby prevent the government from getting the use of its resources. In this connection, the real question is the strength of the Reserve Association. Constituted as it would be, as already explained, it would be practically equivalent to an agency representing the united banks of the country. It would therefore have the same strength that is possessed by the combined banks of the country. The government cannot expect to be stronger in its resources than

the commercial community. If all the banks of the country were to fail, it would not be remarkable if the government should fail also. In fact, it could not collect taxation and might as well suspend efforts at making payment. This is merely a *reductio ad absurdum,* inasmuch as it shows the impossibility of the assumption that the reserve association organized as already suggested would differ in its strength from that of the combined banks, and inasmuch as it emphasizes the fact that a financial strength greater than that of the combined banks is neither attainable nor perhaps desirable. There is no case on record where a large European institution acting as the fiscal agency of the government under which it is organized has failed. Such a failure would imply careless, if not criminal, oversight on the part of the officials entrusted with the supervision of banking, and would besides be evidence of the complete instability and decay of the general business conditions and institutions of the country.

The Question of Suspension

The question of a suspension or temporary inability to pay on the part of such a reserve association is a matter which involves somewhat different considerations. It might be sufficient to say on this point that under no conceivable system, reserve association or other, could conditions be worse than they have been under the national banking system. It can be stated with absolute certainty that at all times when the government has had large and widely diffused deposits in national banks it has had the very greatest difficulty in getting them back, even in times of prosperity and public confidence. During the past ten years it has been customary when the Treasury wanted to draw in some of its deposits to issue what was termed "a call" for deposits. This was habitually given out from 15 to 30 days in advance of the time when the deposits were wanted, and amounted to a notice to the banks that they would have to pay at a certain date. Very often banks sent representatives to the Treasury to beg for more time. It was a difficult matter to get them to liquidate under any conditions.

In times of panic and stringency, the Treasury, instead of calling for deposits, has habitually placed more funds with the banks, if it could command them. Thus, during the panic of 1907, Secretary Cortelyou went so far in the pursuit of this policy as to deposit with the banks practically everything that the Treasury owned in the way of cash, outside of its trust funds, so

that probably there was hardly a week's supply of actual cash in the Treasury at the time when it was in greatest straits. Other instances of the same kind could be cited.

The whole trouble comes from the fact that when the Treasury calls for deposit, it asks for actual money. To give this the banks must cut down their reserve by a corresponding amount, and that usually implies a curtailment of commercial credit. If the funds of the government were regularly on deposit with a reserve association and if the government never "called" for its deposits except in so far as it needed cash for immediate disbursement, just as would be done by any large business house, there would be no occasion for difficulty, but the institution would always be able to meet its obligations so long as it was in a solvent condition. It would never have to contemplate the problem of turning a portion of its reserve over to the Treasury Department. The government would build up its account with the Reserve Association by depositing there the proceeds of taxation and of bond sales as they came in, and it would transfer these claims to its creditors. The capacity of the Reserve Association to meet the demands would be merely a question of its solvency, a question already sufficiently discussed.

Trouble Due to Treasury Calls for Cash

Of course, the whole fallacy in the views of those who speak of the danger of turning over government funds to a private institution lies in the attempt to draw a distinction between the government and the community which it represents. The government cannot be stronger than its subjects. If the latter are represented by an institution which acts as the joint agency of the banks of the country and in that way practically stands for the whole of the business community, the government cannot hope to put itself in a more powerful or solvent condition than the institution which thus has at its disposal the fluid resources of the nation. Its sole anxiety must be that of seeing that the institution in question is properly conducted, and that it does not fall into the hands of selfish persons who may pervert its purpose for their own object. That is a question which is met by the provisions governing organization and management. These have already been discussed, and it has been shown how such an institution can properly be managed in the public interest. If the government has done its share in directing the policy of the institution by appointing able directors to present its views on the controlling board, and if it

Government No Stronger than the People

has properly performed its function of inspection and oversight there is no more to be said. The safety of the institution is equivalent to that of the nation as a whole, and the government could not do better than to trust the public funds to the institution which thus represented the public in its financial aspect.

Reserve Association a Public Institution

§8. The proposed Reserve Association is to be, in fact, a public institution in the highest sense of the word. It would be conducted in the interest of the public, for the good of the public, and its profits above the moderate rate of 5 per cent on capital invested would go to the public authorities. Under those conditions the employment of the Reserve Association as the fiscal agent of the government would in no sense be the turning over of the funds of the government to private individuals. It would be simply the substitution of an effective public institution possessing banking functions and working in close harmony with the banking institutions of the country for another public institution, the Treasury, possessing no equipment for this service, having no necessary relation to the banking mechanism of the country and in every way lacking the equipment that would render it a satisfactory means to the accomplishment of the fiscal purposes of the government.

CHAPTER XXII

INTERNATIONAL POSITION OF THE UNITED STATES

1. Readjustment of the Banking System to Meet Foreign Trade Conditions—2. Uniform Discount Rate and the Flow of Specie—3. United States Not Considered as a Center of Finance—4. Purchase and Sale of Exchange—5. Reserve Association to Do Banking Business Abroad—6. International Flow of Gold—7. Foreign Exchange Banks.

§1. An important element in the plan of banking reform, proposed by the National Monetary Commission, is found in the provision it contains for a new adjustment of our banking system to foreign trade conditions. Such readjustment has long been considered a necessary feature of any plan of reform in banking. The national banking system was established at a time when foreign trade was small and when little or no heed had been given to the peculiar credit requirements of export houses. Since that time, the export business of the United States has greatly expanded. Simultaneously, competition with foreign countries has become much more severe. In this competition, we have found ourselves exceptionally handicapped, owing to the circumstance that foreign banking systems were so much better equipped to furnish the credit needed in financing these international operations.

Readjustment to Meet Foreign Trade

It has been found that our peculiarly subdivided and independent system of banks (1) entirely lacks the power to control international gold movements by changes in the rate of discount; (2) is unable under the terms of the national act to establish branches in foreign countries capable of supplying American exporters with the funds they require in order to meet the peculiar credit conditions there obtaining; (3) could not with entire success develop the mechanism needed for dealing in international exchange; and (4) lacks the unity of policy required to properly finance export movements of commodities.

Practical Defects

These defects in the national system have at times been exemplified in a striking way. This has been true at critical periods of stringency and panic. Less conspicuous, but perhaps more important, has however been the fact that the national system has suffered continuously from these evils and weaknesses, and was unable to supply the necessities of the trade of the country in such a way as to support and encourage its business. The most noticeable feature of the situation has been seen when the gold reserves have been reduced below normal necessities, without any serious action on the part of the banks intended to check the outflow or restore the depleted supply.

It has occasionally happened that the gold resources of the country fell far below normal requirements, reserves were allowed to run down, and danger to solvency and liquidity was encountered.

When a Silver Standard Was Threatened

This was the case during the three years just after the Sherman Silver Purchase Act of 1890, when it appeared that foreign countries were sending back to the United States the securities of American enterprises which failed to command confidence because of the threat then current in American politics that the country would pass to a silver standard. It would not have been possible on that occasion for the banks to prevent the withdrawal of cash funds in payment for the securities, since the real cause of the outflow was entirely beyond their control. A suitably organized system of banking would, however, have managed the operation with far less suffering and stress, would have been able to give earlier and more effective notice to the country of what was occurring and of its causes, and would have been able to rectify and restore the normal supply of gold, after proper legislative action had been taken. In this way the crisis of 1893 might have been prevented, or greatly mitigated.

Gold Imports in 1907

During the panic of 1907, when reserves were being drawn down by depositors and by small banks which feared that they would become unable to pay cash, a suitably-organized banking system would have succeeded in drawing gold from abroad much more readily than was actually done. There were many banking houses during the panic of 1907 which imported large quantities of gold and placed it at the disposal of their correspondents. The same was true on previous occasions when similar, although less urgent, needs made themselves felt. But there was no general or concerted attempt to rectify the situation by raising rates of discount, or by

offering foreign countries the inducements necessary in order to get them to part with their specie in favor of the United States.

Throughout the whole period of our foreign trade development during the past 20 years, it has been necessary for exporters to rely upon accommodations at foreign banks or at private banking houses, which, although efficient so far as their operations extended, necessarily worked upon a limited scale and without reference to the broader needs of the country. There has been constant complaint, therefore, of the difficulties connected with the obtaining of credit in the proper form and amount for the conduct of foreign trade operations. For these reasons, the question is always, and properly, asked, in connection with any proposed system of banking legislation, how far and in what way it will meet the evils which have developed in the ways already described.

Broader Needs of the Country Not Recognized

§2. The most important change in our relation to foreign countries in regard to the international flow of specie would be found in the introduction of some element of coöperative or combined control over such movements, exerting itself by the establishment of a uniform rate of discount which would be raised or lowered as circumstances might demand. One of the most important of these circumstances would be the condition of our foreign trade and the state of our international balance. If conditions had developed in such a way as to create tendencies toward the outflow of specie, a properly-organized banking system would do what was needed in order to moderate and control this tendency. In foreign countries, such work is performed by the great banking institutions which act as representatives of the combined banks of the nation. Thus the banks of France, England, Germany, etc., find a large part of their activity directed toward the regulation of rates of discount in such a way as to prevent the gold stock of their clientele from being unduly depleted, or to build it up when circumstances call for such steps.

Discount Rate and the Flow of Specie

No such policy is possible in a country where there is no coöperative agency to regulate the rate of discount. It is impossible to expect banks, acting on their own initiative, in competition with others, and controlled primarily by a desire for profit, to pursue a policy which would merely reduce their own earnings and would not result in conserving the gold supply of the country. If they could act as a unit, there would be many cases in which they

No Force in this Country to Conserve the Gold Supply

would agree to raise the rate of discount to customers in order to check borrowing, reduce exportation of gold, and put a brake upon lines of business which were going too far for the general good of the country. Acting alone, they cannot be expected to sacrifice themselves for such a purpose, particularly as such self-sacrifice would be of little or no use where it was not practiced by others.

Fundamentally a great service to our foreign trade which would be performed through a coöperative reserve institution would be that of controlling the specie movement. The knowledge that a banking mechanism of such a kind, comparable in strength and vitality to those existing elsewhere, had been established here would greatly strengthen the financial position of American borrowers and American enterprises abroad, and would immensely improve our general position in the world community of finance.

Position of the United States in the World of Finance

§3. At present, the United States does not receive the consideration as a center of finance and industry to which its rank in wealth entitles it. International enterprises prefer to establish their headquarters in countries whose banking systems are upon a more stable basis. They do not care to run the risk of such occurrences as the panic of 1907, suspensions of payment, shortages of accommodation, and general financial disturbance. They find it more advantageous to operate where they are free from such unnecessary dangers, and where at the same time they can be assured of any amount of accommodation for which they can show good and sufficient security of the proper kind. All these considerations make against our status in the international financial market and tend to drive enterprises away from our shores when the high character of the management is such that it can select the place of principal operation at will. The effect is to cut us off from much desirable business and in a measure to isolate the American market.

Isolation of the American Market

The lack of coöperation among our banks prevents the establishment of any uniform system or standard for financial transactions, such as exists in the principal countries abroad, and it is partly due to this fact that American securities are looked upon with doubt by many foreign investors and are listed only with hesitation by foreign exchanges. The establishment of a coöperative institution would bring about a great change in these conditions. It would establish here a mechanism which is not a central bank,

but which would be comparable in power and prestige with the great banks of Europe, would ensure suitable supplies of credit when they were needed, and would thereby prevent the recurrence of bank suspensions and difficulties similar to those of 1907 and preceding panic years.[1]

Precisely how the proposed plan would work and by what mechanism it would bring about the results indicated may now be pointed out. At present, banks of the United States are for the most part too small in capital to engage in large international transactions. This is true both of national and state institutions. Partly as a result of law, partly in consequence of the dictates of sound business policy, it is not wise for them to tie up their funds in the long-term operations needed in international trade. They are not able under existing conditions to be sure of rediscount accommodations that would suffice to give them the assurance they need in dealing with applicants for loans on international paper.

The Bank Mechanism the Country Needs

Such new mechanism as may be established must therefore have large capital. It must further be able either to "carry" enterprises for such periods of time as they may require in international operations, or to secure through foreign banking institutions the aid necessary to do so. Further it must have power to operate in foreign countries and to adjust its methods to those of the credit systems which there prevail. None of these things is now practicable. The problem is how to supply them. From another point of view, the proposition assumes a twofold form—(1) that of changing our banking organization so as to supply the amount of capital and the type of credit needed; and (2) that of standardizing local paper so as to make it pass current in world markets.

Large Capital Necessary

§4. The fundamental operation in financing foreign trade transactions is the purchase and sale of exchange. This amounts practically to the making of loans by the general methods already described (see Chapter V on "Commercial Paper"), but in such

[1]The National Monetary Commission says of the plan: The National Reserve Association is given ample power to protect its own reserves, in order that it may be able at all times to exercise its most important function—that of sustaining the commercial and public credit of the country. For the purpose of strengthening its own reserves it may, first, attract gold from other countries by an advance in its discount rate; second, purchase and borrow gold and give security for its loans, including the hypothecation of government bonds; third, buy and sell foreign bills of exchange. Short-time foreign bills have been found elsewhere most effective as a means of replenishing a gold supply, and of preventing the exportation of gold at critical times.

a way as to finance transactions involving exportation and importation. An exporter sells a bill of goods to a buyer in Rio Janeiro. He wishes to have the returns for the goods immediately, and so draws at a specified number of days upon his correspondent in that city. This draft, accompanied by the necessary documents, is taken by him to a bank and is there presented for discount. The bank examines the draft and the attached documents. Finding all satisfactory, and being certain of the solvency of the customer who asks for the discount, it grants the accommodation desired. Thereupon, it stands possessed of the claim upon the buyer in Rio Janeiro, the exporter who discounted the draft being meanwhile under obligation for the amount of the loan only in case there should be a default at the other end.

Purchase of Bills of Exchange

Such loans are necessarily longer in their period than ordinary commercial paper, and the business probably could not be done in many instances upon the narrow margin of time which is usual in domestic trade. This has prevented national banks from engaging actively in this kind of operation notwithstanding that such loans are among the best and safest that can be found. Banks do not care to have too great a proportion of their funds tied up in loans that can be realized upon only with possible difficulty. A large proportion of this business has, therefore, gone in the past to private institutions, and has been dealt with by them only sporadically and in many instances unsatisfactorily.

Why Banks Avoid Foreign Business

One fundamental necessity in the case is that of providing some method that will permit a rediscount of such paper. This function would be performed to best advantage by a Reserve Association such as has been spoken of.

If such an institution stood ready to advance funds upon paper arising out of foreign trade operations, several desirable effects would be brought about. The trade itself would be greatly facilitated, because of the increased possibility of getting current accommodations at the reasonable rates needed in the business. The plan would render material aid also, because of the encouragement afforded by it to ordinary banks to take up such paper when offered to them. This would tend to keep the rate of discount at a low figure since it would ensure the banks' power to hypothecate the bills of exchange upon terms as favorable as those accorded to any kind of paper originating elsewhere. It would undoubtedly bring

How a Discount Market Would Work

about a more friendly attitude on the part of the banking public toward export enterprises in general. On this point the National Monetary Commission says:

> A wider domestic market for the commercial paper we have described will be found in the changes which are likely to take place under the provisions of the bill submitted, in the investment of the surplus funds of the banks, and by surplus funds in this connection we do not refer to moneys deposited with reserve agents, but to funds for which there may be no legitimate local demand. The surplus funds referred to are now deposited perhaps through correspondents in New York at 2 per cent interest. The New York banks are usually obliged to loan them on call on stock exchange collaterals, inducing at times dangerous speculative conditions, with the probability that when the money is withdrawn the necessary calling of loans may cause disturbances in reserves and in the market and sometimes lead to panics.
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> We propose by the provision of the bill submitted to enable the banks to invest their surplus funds of the character we have described in notes or bills of exchange representing the industries or the products of the United States. It may be that they will not be able in making these loans to obtain the full rate current for discounts of commercial paper, as they will have to compete with foreign banks for a portion of the business, but they will certainly receive more than 2 per cent for their money, and they will have in their portfolio commercial paper created for legitimate purposes which they can take to the district branch and have transformed into cash or a cash credit at any hour of any business day of the year.

§5. In order to facilitate this foreign business, the proposed plan of the National Reserve Association, one form of which has been presented by the National Monetary Commission, proposes to give power to the association to open banking accounts in foreign countries and to do business there along lines that are appropriate or necessary to the carrying out of this branch of its operations. The Monetary Commission's bill says:

To Have Banking Accounts in Foreign Countries

> The National Reserve Association shall have power to open and maintain banking accounts in foreign countries and to establish agencies in foreign countries for the purpose of purchasing, selling, and collecting foreign bills of exchange, and it shall have authority to buy and sell, with or without its indorsement, through such correspondents or agencies, checks or prime foreign bills of exchange arising out of commercial transactions, which have not exceeding ninety days to run, and which bear the signatures of two or more responsible parties.

It is evident that this provision would furnish the association with the power needed to establish close business connections with foreign countries. The limitation by which the paper is to run not more than 90 days and to bear the signatures of two responsible parties is intended to prevent the use of the funds of the association in financing very long period loans, and has the same object as the limitation of domestic loans to 28-day transactions under all except very carefully safeguarded conditions. The provisions just quoted would merely furnish the basis for the extension of the business of the National Reserve Association beyond the confines of the United States. It would thus be fundamental because it would permit the creation of an international banking mechanism with headquarters in the United States. This is now entirely lacking in our present national banking system.

An International Banking Mechanism

The National Reserve Association is intended to do business only with banks and is not to be permitted to undertake any independent operations, in domestic trade. Communication with the public of the United States, therefore, is to be had solely through the constituent banks which have taken stock in the Reserve Association.[2] We have already seen how carefully it is intended to limit the operations of these banks in order that they may not succeed in securing the use of funds of the association for purposes that might be dangerous or that might result in inflation. A special

Special Authorization as to International Business

[2]Considerable difference of opinion on the question whether bills should be bought only from the banks still exists among expert students. With reference to this subject, Mr. Frank B. Anderson, president of the Bank of California of San Francisco, says:

"The power to make its rate effective would be the Association's greatest weapon of offense and defense. It will, if efficient, give the elasticity to our banking system which is so desirable—elasticity means contraction and expansion, not expansion alone. In normal times the influence of the Association's rate would be practically nil. Under the plan the Association would be a beggar at the doors of its depositors, dependent upon them for the investment of its funds; failing there, all of its funds would have to go abroad for investment. On the other hand, when the banks were loaned up and actual stringency existed, the banks would have to go to the Association and accept such terms as it imposed; that is, the Association rate will be effective only when the banks have to borrow. In other words, the Association can only act on the defensive and its influence will not be felt until inflation has got under pretty full headway. World conditions might be so settled that the Association felt that the business public was entitled to lower rates, and that there was no danger in allowing business to expand. It certainly would not be wise to encourage the banks to borrow the Association's money at such a time. On the other hand, it would be conservative for the Association to let some of its money out by purchasing bills in the open market, because it would be in a position to control the situation when necessary. The purchases of the Association would be only of the highest grades of short-time paper, and the competition with the banks would be practically negligible; the Association would certainly be able to serve the nation and the banks more intelligently and with more safety if it could purchase and sell in the open market. If the Association is to be charged with the responsibility of guarding the reserves of the banks and the gold supply of the country, it should be given the power to make its rate effective. If the lessons of history are worth anything, the Association will not be fully successful unless it can make its rate effective."

provision would, therefore, be needed to expand the scope of the National Reserve Association's work in connection with international trade. Were this not done, the purchase of paper growing out of foreign trade transactions would be forbidden to the Reserve Association. The following section of the plan proposed by the National Monetary Commission shows what authority it is intended to give to the National Reserve Association in this connection:

> **The National Reserve Association shall have power to purchase from its subscribing banks and to sell, with or without its indorsement, checks or bills of exchange arising out of commercial transactions as hereinbefore defined, payable in such foreign countries as the board of directors of the National Reserve Association may determine. These bills of exchange must have not exceeding ninety days to run, and must bear the signatures of two or more responsible parties, of which the last one shall be that of a subscribing bank.**

While this provision would give a large degree of discretion to the Board of Directors of the Reserve Association in limiting the classes of paper in which they were willing to trade in international business, it would not permit any discrimination between different institutions. The different banks would be guaranteed the same access to the Reserve Association as any other of their number and the association would be able to limit itself only in regard to certain specified classes of transactions.

Tests of Paper

By requiring that each bank offering paper for rediscount shall place its signature upon the paper offered to the Reserve Association for rediscount, the plan makes it certain that each piece of paper will have been tested by the bank to which application is originally made, and that nothing will have been done except upon the request and with the approval of some bank which so strongly backs its judgment in the matter as to make itself liable by placing its signature upon the paper.

International Flow of Gold

§6. A power incidental to, and correlative with, the authority already granted in the provision referred to is that of attracting gold coin and bullion from foreign countries whenever necessary to rectify the balance of trade and to supply needed reserve resources in the United States. On that point the plan of the National Monetary Commission provides as follows:

> **Sec. 34. The National Reserve Association shall have power, both at home and abroad, to deal in gold coin or bullion, to make loans thereon, and to contract for loans of gold coin or bullion,**

> giving therefor, when necessary, acceptable security, including the hypothecation of any of its holdings of United States bonds.

The effect of this provision would be to permit the association at times when the currents of international trade had gone against the United States, thereby depleting our gold supply, to obtain gold abroad, practically by purchase, and to arrange for its importation into the United States. This at times is a necessary function in order to avert stringency and supply actual gold to meet demands for reserves. In times past, when stringency has occurred, there were no means of obtaining gold by united action on the part of the banks, but it was necessary to rely entirely upon the sporadic activities of large banks in order to secure the import of gold. The new plan would place the power, and therewith the responsibility, for such work upon the National Reserve Association. The banks themselves would thereby be relieved of the necessity of concerning themselves further about the general question of gold supply as compared with that of foreign countries, and would be enabled to look directly to the National Reserve Association for such accommodation as they might deem necessary.

Banks Would Not Be Concerned About Gold Supply

By the side of this provision may be set another, which, although not absolutely required, is likely to be of distinct service in the management of foreign trade relations. This is the power to deal in the national bonds not only of the United States but of foreign countries.

Dealing in Bonds of Other Countries

The Monetary Commission plan makes the following provision on that score:

> The National Reserve Association may invest in United States bonds; also in obligations, having not more than one year to run, of the United States or its dependencies, or of any state, or of foreign governments.

§7. Thus far, what has been said has had reference entirely to the operations of a National Reserve Association. It has been assumed that the transactions involved in the financing of foreign trade could be attended to by the banks, provided they were afforded a means of obtaining rediscounts. It is not certain, however, that such would be the case. The operations of national banks are primarily domestic in character, and bankers hesitate to allow their funds to become involved in business requiring so long a term of credit as is implied in international operations. It is therefore

Foreign Exchange Banks

thought necessary by some that a new set of institutions should be authorized for the purpose of providing more adequately for the needs of our foreign trade. They would be institutions which would specialize in foreign business. On this point, the National Monetary Commission has put forward the following plan as Section 57 of its bill:

> Sec. 57. That banking corporations for carrying on the business of banking in foreign countries and in aid of the commerce of the United States with foreign countries and to act when required as fiscal agents of the United States in such countries may be formed by any number of persons, not less in any case than five, who shall enter into articles of association which shall specify in general terms the object for which the banking corporation is formed and may contain any other provisions not inconsistent with the provisions of this section which the banking corporation may see fit to adopt for the regulation and conduct of its business and affairs, which said regulations shall be signed, in duplicate, by the persons uniting to form the banking corporation, and one copy thereof shall be forwarded to the Comptroller of the Currency and the other to the Secretary of State, to be filed and preserved in their offices.
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> That the persons uniting to form such banking corporation shall under their hands make an organization certificate which shall specify, first, the name assumed by such banking corporation, which name shall be subject to approval by the Comptroller; second, the foreign country or countries or the dependencies or colonies of foreign countries or the dependencies of the United States where its banking operations are to be carried on; third, the place in the United States where its home office shall be located; fourth, the amount of its capital stock and the number of shares into which the same shall be divided; fifth, the names and places of residence of the shareholders and the number of shares held by each of them, and, sixth, a declaration that said certificate is made to enable such persons to avail themselves of the advantages of this section.
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> That no banking corporation shall be organized under the provisions of this section with a less capital than two million dollars, which shall be fully paid in before the banking corporation shall be authorized to commence business, and the fact of said payment shall be certified by the Comptroller of the Currency and a copy of his certificate to this effect shall be filed with the Secretary of State; provided, that the capital stock of any such bank may be increased at any time by a vote of two-thirds of its shareholders with the approval of the Comptroller of the Currency and that the capital stock of any such bank which exceeds two million dollars may be reduced at any time to the sum of two million dollars by the vote of shareholders owning two-thirds of the capital.

That every banking corporation formed pursuant to the provisions of this section shall for a period of twenty years from the date of the execution of its organization certificate be a body corporate, but shall not be authorized to receive deposits in the United States nor transact any domestic business not necessarily related to the business being done in foreign countries or in the dependencies of the United States. Such banking corporations shall have authority to make acceptances, buy and sell bills of exchange, or other commercial paper relating to foreign business, and to purchase and sell securities, including securities of the United States or of any state in the Union. Each banking corporation organized under the provisions of this section shall have power to establish and maintain for the transaction of its business a branch or branches in foreign countries, their dependencies or the dependencies of the United States at such places and under such regulations as its board of directors may deem expedient.

A majority of the shares of the capital stock of such banking corporation shall be held and owned by citizens of the United States or corporations chartered under the laws of the United States or of any state of the Union, and a majority of the members of the board of directors of such banking corporations shall be citizens of the United States. Each director shall own in his own right at least one hundred shares of the capital stock of the banking corporation of which he is a director.

Whenever the Comptroller shall become satisfied of the insolvency of any such banking corporation he may appoint a receiver who shall proceed to close up such corporation in the same manner in which he would close a national bank, the disposition of the assets of the branches to be subject to any special provisions of the laws of the country under whose jurisdiction such assets are located.

The annual meeting of every such banking corporation shall be held at its home office in the United States, and every such banking corporation shall keep at its home office books containing the names of all stockholders of such banking corporation and members of its board of directors, together with copies of the reports furnished by it to the Comptroller of the Currency exhibiting in detail and under appropriate heads the resources and liabilities of the banking corporation. Every such banking corporation shall make reports to the Comptroller of the Currency at such times as he may require, and shall be subject to examinations when deemed necessary by the Comptroller of the Currency through examiners appointed by him; the compensation of such examiners to be fixed by the Comptroller of the Currency.

Any such banking corporation may go into liquidation and be closed by the vote of its shareholders owning two-thirds of its stock.

Any bank doing business in the United States and being the

owner of stock in the National Reserve Association may subscribe to the stock of any banking corporation organized under the provisions of this section, but the aggregate of such stock held by any one bank shall not exceed ten per centum of the capital stock of the subscribing bank.

Of this provision, the Commission itself says:

> Section 57 of the bill submitted provides for the incorporation of banks to do business in foreign countries. We assume that it is not necessary to call attention to the desirability of making every reasonable effort to promote our foreign trade and to establish closer commercial and financial relations with foreign countries. The impediments in the way of the development of our international trade are numerous. Perhaps none of these is more important than the absence of American banking facilities in other countries and the lack of knowledge abroad of our financial resources and of the strength and character of our banking institutions. The status of the United States as one of the great powers in the political world is now universally recognized, but we have yet to secure recognition as an important factor in the financial world. This condition of affairs is likely to remain unchanged as long as practically all our purchases and sales abroad are financed by foreign bankers. We anticipate that the changes in the currents of trade which will follow the opening of the Panama Canal will tend to the enlargement of our international commerce.

If this or some similar plan were to be adopted, provision would practically be made for highly-specialized institutions authorized to do business with particular parts of the world and to maintain in the United States simply a head office without branches on our soil. While branches could be organized abroad and would be so organized in order to carry out the purposes for which the enterprise was inaugurated in the first place, they would not be located in the United States and hence would not infringe at all upon the existing system of free banking.

No Interference With Free Banking

The effect of the new class of banks would be merely that of supplying special and expert banking skill in connection with our foreign trade. The new system would result in establishing institutions in those countries in which we transact business closely connected with the National Reserve Association and its foreign agencies, in the same way that domestic banks would be connected with, and would look to, the proposed National Reserve Association itself and its fifteen branches in the United States.

The functions of these banks organized to engage in foreign trade would be very similar to those of the chartered banks in

Great Britain which are intended to carry on banking operations in the Orient and in the British foreign possessions generally. It is the function of these institutions to facilitate, so far as possible, transactions between English exporters and importers on the one hand and merchants and producers in the countries with which they are trading on the other. The credit situation in this trade has a special character in that differences in terms and periods of lending conditions, of purchase and sale of goods, and the like, exist in various countries depending upon the varying customs of the people. These call for direct study by bankers and for the adjustment of credit institutions thereto. The result is that such banks are able to accomplish a distinct service which could not be had from other institutions. They get their ultimate support from the Bank of England, which rediscounts their paper, just as the proposed new class of institutions for the United States would get support through the rediscounts granted it by a National Reserve Association.

Functions of British Chartered Bank

The change in the present situation which would result from the proposed plan would really be twofold: (1) The recognition of a new set of institutions properly organized and authorized to supply capital for use in foreign trade; and (2) the linking of these institutions and of the financial and banking system of the country as a whole to the National Reserve Association by authorizing it to do a rediscount business in foreign trade. The effect of these changes would simply be to give to those who wished to engage in foreign trade somewhat the same facilities that now exist in connection with domestic business. Foreign business would in no way be preferred to domestic, but the exporter would be assured of the same access to loanable capital as the local manufacturer.

Foreign Business Would Be as Well Provided for as Domestic

The effect of such changes would be that of giving the United States a decidedly different status in the commercial world as compared with that which it occupies today. Not only would it share in many international financial operations from which it is today practically excluded, but it would extend to American merchants the accommodation which they now have to seek from foreign banks, sometimes with indifferent success, when they were engaged in selling their products in foreign countries.

One of the chief obstacles to our successfully entering foreign markets has been the fact that our exporters were not in position to accommodate themselves to the longer terms of credit and special

conditions there prevailing. They were often obliged to insist upon immediate or short-period payment, while their European competitors, having rediscount facilities at hand, could grant a much longer period to the purchaser who expected to retail the goods to consumers. Important as the establishment of a coöperative institution is in domestic trade, it is probable that the proper conduct of foreign trade is even more directly dependent upon the introduction of suitable facilities for making loans and securing rediscounts than is true of domestic borrowers.

Advantages Enjoyed by Our European Competitors

CHAPTER XXIII

CONSTITUTIONALITY OF A NATIONAL RESERVE ASSOCIATION

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Preliminary Statement

Upon the supposition that Congress may undertake the reorganization of our present national currency system, I understand that an opinion is asked regarding the constitutionality of a plan of reorganization proposed by the National Citizens' League involving substantially the following features:

The United States shall charter, for a term of years, a corporation to be known as the National Reserve Association, with an authorized capital equal to twenty per cent of the capital of the subscribing banks, and a head office in Washington, D. C. All national banks, and incorporated state banks, savings banks, and trust companies, receiving deposits, may (under certain prescribed conditions as to capital, reserves, examinations, reports, and so forth) subscribe to the capital stock of the National Reserve Association up to a certain percentage of their own stock. Stock in the National Association shall be non-transferable and if a subscriber reduces its capital or ceases business its stock shall be surrendered proportionately in return for its par value in cash. The country is to be divided into fifteen "districts," with a branch of the Association in each, and the Association and its branches are to be exempt from state and local taxation except upon real estate. Net earnings are to be divided between stockholders in the Association, the United States, and the creation of a surplus reserve for the Association.

Subscribing banks in contiguous territory are to be formed into "local associations," with corporate powers, a minimum membership of ten banks, and a combined capital of at least $5,000,000. Every bank will belong to some local association, and all of the latter are grouped into fifteen divisions corresponding to the above-mentioned "districts." Detailed provision is made for the choice of

directors and governors of local associations and of the National Association.

The privileges of the local association and of the National Association are to be equitably extended to every subscribing bank. The National Association may rediscount for any subscribing bank notes based upon actual commercial transactions (not for carrying investment securities) to an amount not exceeding the capital of the subscriber. If the paper rediscounted has over twenty-eight days to run, it must be guaranteed by the subscriber's local association for a commission, and must mature in not over four months. Subject to the approval of certain officials, direct loans may be made to subscribing banks by the Association when the public interests so require, up to three-fourths of the value of satisfactory securities pledged therefor. The borrowing subscriber must keep on deposit with the Association a certain percentage of its loan item. The Association may also purchase from subscribers prime bills maturing in not over ninety days.

The Association shall be the principal fiscal agent of the United States, receiving on deposit the cash receipts of the latter, and making its disbursements. The United States and the subscribing banks are to be the sole depositors, and have the sole domestic transactions with the Association; but the Association may invest in obligations of the United States, the states, or of certain foreign governments, it may deal in gold coin or bullion, or foreign exchange, and may establish agencies abroad.

National banks shall issue no more circulating notes, and any retired shall not be reissued. The Association shall for one year offer to buy at par the two per cent bonds now deposited with the United States to secure bank circulation, and shall assume responsibility for the notes secured thereby. Its own notes shall be issued in place of bank circulation thus retired, with the object of wholly replacing the present bond-secured circulation as soon as convenient. It shall hold United States bonds thus purchased for not less than ten years, except that with the government's consent it may, after two years, sell not over $50,000,000 of them annually. The Association may also issue additional circulating notes, provided it secure all of its note or deposit demand liabilities by a thirty three per cent gold reserve and the remainder by bankable commercial paper, United States bonds, or other kinds of lawful money. The Association's notes shall be a first lien upon all of

its assets, shall be redeemable in gold, and shall be receivable for all demands due to or from the United States (unless specifically payable in gold), and for all due to or between subscribing banks. The Association shall make weekly public reports to the comptroller of the currency, and full reports five times a year.

Opinion

The power of Congress to charter a corporation authorized to receive deposits, make discounts, and to issue bills designed to circulate as money (though not necessarily legal tender) became the subject of vigorous discussion immediately after the adoption of the Constitution. The third session of the First Congress passed an act (1 St. L. 191) incorporating the first Bank of the United States for twenty years, with such powers, which was approved by President Washington on February 25, 1791. One-fifth of its capital stock of $10,000,000 was to be subscribed by the United States, and three-fourths of the amount of private subscriptions was to be paid in the interest-bearing public debt of the United States. Its demand notes were made receivable in all payments to the government. Washington sought the advice of various members of his cabinet upon the constitutionality of the act, before signing it, and opinions adverse to it were given by Secretary of State Thomas Jefferson and Attorney-General Edmund Randolph, and in its favor by Secretary of the Treasury Alexander Hamilton. The arguments of the latter carried conviction to the President. Though Hamilton's opinion is without force as a judicial precedent, great weight has always justly attached to it, not only on account of its author's high reputation as a lawyer and his relation as a statesman to the measure in question, but also because of the breadth and cogency of its reasoning, which has been largely adopted by the courts.

In brief outline, Hamilton's argument was as follows:

In addition to various enumerated powers expressly conferred upon Congress by the Constitution, Congress is authorized "to make all laws which shall be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the government of the United States, or in any department or officer thereof." Cons., Art. I, sec. 8, clause 18. "Necessary" here does not mean absolutely and indispensably necessary, but no more than "needful, requisite, incidental, useful, or

conducive to," and so gives Congress a fair choice of means in carrying out the authorized ends of the federal government. If a national bank, then, is an incidental or useful means of exercising any power vested in the United States government, it may constitutionally be chartered by Congress. "Accordingly it is affirmed that it has a relation, more or less direct, to the power of collecting taxes, to that of borrowing money, to that of regulating trade between the States, and to those of raising and maintaining fleets and armies. To the two former the relation may be said to be immediate; and in the last place it will be argued, that it is clearly within the provision which authorizes the making of all *needful rules and regulations* concerning the *property* of the United States, as the same has been practiced upon by the government.

"A bank relates to the collection of taxes in two ways—indirectly, by increasing the quantity of circulating medium and quickening circulation, which facilitates the means of paying directly, by creating a *convenient species* of medium in which they are to be paid." It also provides a safe and ready means of transferring collections from one part of the country to another, and it prevents the evils to trade that result from locking up in the government vaults large sums of money not needed for current disbursements which are thus withdrawn from circulation.

"A bank has a direct relation to the power of borrowing money, because it is a usual, and in sudden emergencies an essential, instrument in the obtaining of loans to government." Taxes and loans from individuals are often too slow in an exigency, and a bank enables the ready accumulation of a fund to be loaned.

> "The institution of a bank has also a natural relation to the regulation of trade between the States, in so far as it is conducive to the creation of a convenient medium of *exchange* between them, and to the keeping up a full circulation, by preventing the frequent displacement of the metals in reciprocal remittances. Money is the very hinge on which commerce turns. And this does not merely mean gold and silver; many other things have served the purpose, with different degrees of utility. Paper has been extensively employed."

The government may use its property, produced by taxation, for the general welfare, and may thus become a joint proprietor in a national bank like the one contemplated, in which the United States was to subscribe one-fifth of the $10,000,000 capital.

> Finally, "there is a sort of evidence on this point, arising from an aggregate view of the Constitution, which is of no inconsiderable weight: the very general power of laying and collecting taxes, and appropriating their proceeds—that of borrowing money indefinitely—that of coining money, and regulating foreign coins—that of making all needful rules and regulations respecting the property of the United States. These powers combined, as well as the reason and nature of the thing, speak strongly this language: that it is the manifest design and scope of the Constitution to vest in Congress all the powers requisite to the effectual administration of the finances of the United States. As far as concerns this object, there appears to be no parsimony of power."

The legality of the first Bank of the United States seems never to have been questioned in the federal courts. Its charter expired in 1811.

In 1816 the second Bank of the United States was chartered by Congress (2 St. L. 266) for twenty years with a capital of $35,000,000, one-fifth of which was subscribed by the United States. Three-fourths of the amount of private subscriptions was payable either in coin or in the public debt of the United States contracted at the time. The bank's notes were made receivable in all payments to he government, the bank was made a depository of the public money, and was required to transfer the public funds from place to place, to pay public creditors, and to perform the duties of loan commissioners in the states.

The validity of this institution was judicially challenged in the case of McCulloch v. Maryland, 4 Wheat. 316, in 1819. Maryland attempted to tax the issue of notes by a local branch of the bank, and in defense of this urged, among other reasons, the invalidity of its charter. The cause of the bank was advocated before the United States Supreme Court by Webster, Pinkney, and Attorney-General Wirt, all great lawyers, who used substantially Hamilton's arguments. Webster said:

> "A bank is a proper and suitable instrument to assist the operations of the government, in the collection and disbursement of the revenue; in the occasional anticipations of taxes and imposts; and in the regulation of the actual currency, as being a part of the trade and exchange between the States. It is not for this court to decide whether a *bank*, or *such a bank* as this, be the *best* possible means to aid these purposes of government.

Such topics must be left to that discussion which belongs to them in the two houses of Congress. Here, the only question is, whether a bank, in its known and ordinary operations, is capable of being so connected with the finances and revenues of the government, as to be fairly within the discretion of Congress, when selecting means and instruments to execute its powers and perform its duties." 4 Wheat., 325.

The Attorney-General said:

"If, therefore, the act of Congress establishing the bank was necessary and proper to carry into execution any one or more of the enumerated powers, the authority to pass it is expressly delegated to Congress by the Constitution. We contend that it was necessary and proper to carry into execution several of the enumerated powers, such as, the power of levying and collecting taxes throughout this widely extended empire; of paying the public debts, both in the United States and in foreign countries; of borrowing money, at home and abroad; of regulating commerce with foreign nations, and among the several States; of raising and supporting armies and a navy; and of carrying on war. That banks dispersed throughout the country are appropriate means of carrying into execution all these powers, cannot be denied." 4 Wheat., 353-54.

Pinkney said:

"If, then, all the powers of the national government are sovereign and supreme; if the power of incorporation is incidental, and involved in the others; if the degree of political necessity which will justify a resort to a particular means, to carry into execution the other powers of the government, can never be a criterion of judicial determination, but must be left to legislative discretion; it only remains to inquire, whether a bank has a natural and obvious connection with other express or implied powers, so as to become a necessary and proper means of carrying them into execution. A bank might be established as a branch of the public administration without incorporation. The government might issue paper upon the credit of the public faith, pledged for its redemption, or upon the credit of its property and funds. Let the office where this paper is issued be made a place of deposit for the money of individuals, and authorize its officers to discount, and a bank is created. It only wants the forms of incorporation. But, surely, it will not be pretended that clothing it with these forms would make such an establishment unconstitutional. In the bank which is actually established and incorporated, the United States are joint

stockholders, and appoint joint directors; the secretary of the treasury has a supervising authority over its affairs; it is bound, upon his requisition, to transfer the funds of the government wherever they may be wanted; it performs all the duties of commissioners of the loan office; it is bound to loan the government a certain amount of money on demand; its notes are receivable in payment for public debts and duties; it is intimately connected, according to the usage of the whole world, with the power of borrowing money, and with all the financial operations of the government. It has, also, a close connection with the power of regulating foreign commerce, and that between the different States. It provides a circulating medium, by which that commerce can be more conveniently carried on, and exchanges may be facilitated. It is true, there are state banks by which a circulating medium to a certain extent is provided. But that only diminishes the quantum of necessity, which is no criterion by which to test the constitutionality of a measure. It is also connected with the power of making all needful regulations for the government of the territory, 'and *other property* of the United States.' If they may establish a corporation to regulate their territory, they may establish one to regulate their property. Their treasure is their property, and may be invested in this mode. It is put in partnership; but not for the purpose of carrying on the trade of banking, as one of the ends for which the government was established; but only as an instrument or means for executing its sovereign powers. This instrument could not be rendered effectual for this purpose but by mixing the property of individuals with that of the public. The bank could not otherwise acquire a credit for its notes. Universal experience shows that, if altogether a government bank, it could not acquire, or would soon lose, the confidence of the community." 4 Wheat., 388-90.

The decision of the court unanimously sustained the bank. Mr. Chief Justice Marshall, in the course of the opinion concurred in by all the judges, said:

"Although, among the enumerated powers of government, we do not find the word 'bank' or 'incorporation,' we find the great powers to lay and collect taxes; to borrow money; to regulate commerce; to declare and conduct a war; and to raise and support armies and navies. The sword and the purse, all the external relations, and no inconsiderable portion of the industry of the nation, are entrusted to its government. It can never be pretended that these vast powers draw after them others of inferior

importance, merely because they are inferior. Such an idea can never be advanced. But it may with great reason be contended that a government entrusted with such ample powers, on the due execution of which the happiness and prosperity of the nation so vitally depends, must also be entrusted with ample means for their execution. The power being given, it is the interest of the nation to facilitate its execution. It can never be their interest, and cannot be presumed to have been their intention, to clog and embarrass its execution by withholding the most appropriate means. Throughout this vast republic, from the St. Croix to the Gulf of Mexico, from the Atlantic to the Pacific, revenue is to be collected and expended, armies are to be marched and supported. The exigencies of the nation may require that the treasure raised in the north should be transported to the south, *that* raised in the east conveyed to the west, or that this order should be reversed. Is that construction of the Constitution to be preferred which would render these operations difficult, hazardous, and expensive? Can we adopt that construction (unless the words imperiously require it), which would impute to the framers of that instrument, when granting these powers for the public good, the intention of impeding their exercise by withholding a choice of means? If, indeed, such be the mandate of the Constitution, we have only to obey; but that instrument does not profess to enumerate the means by which the powers it confers may be executed; nor does it prohibit the creation of a corporation, if the existence of such a being be essential to the beneficial exercise of those powers. It is, then, the subject of fair inquiry, how far such means may be employed.

"It is not denied, that the powers given to the government imply the ordinary means of execution. That, for example, of raising revenue, and applying it to national purposes, is admitted to imply the power of conveying money from place to place, as the exigencies of the nation may require, and of employing the usual means of conveyance. But it is denied that the government has its choice of means; or, that it may employ the most convenient means, if, to employ them, it be necessary to erect a corporation.

"On what foundation does this argument rest? On this alone: The power of creating a corporation, is one appertaining to sovereignty, and is not expressly conferred on Congress. This is true. But all legislative powers appertain to sovereignty. The original power of giving the law on any subject whatever, is a sovereign power; and if the

government of the Union is restrained from creating a corporation, as a means for performing its functions, on the single reason that the creation of a corporation is an act of sovereignty; if the sufficiency of this reason be acknowledged, there would be some difficulty in sustaining the authority of Congress to pass other laws for the accomplishment of the same objects.

"The government which has a right to do an act, and has imposed on it the duty of performing that act, must, according to the dictates of reason, be allowed to select the means; and those who contend that it may not select any appropriate means, that one particular mode of effecting the object is excepted, take upon themselves the burden of establishing that exception.

* * * * *

"The power of creating a corporation, though appertaining to sovereignty, is not, like the power of making war, or levying taxes, or of regulating commerce, a great substantive and independent power, which cannot be implied as incidental to other powers, or used as a means of executing them. It is never the end for which other powers are exercised, but a means by which other objects are accomplished. No contributions are made to charity for the sake of an incorporation, but a corporation is created to administer the charity; no seminary of learning is instituted in order to be incorporated, but the corporate character is conferred to subserve the purposes of education. No city was ever built with the sole object of being incorporated, but is incorporated as affording the best means of being well governed. The power of creating a corporation is never used for its own sake, but for the purpose of effecting something else. No sufficient reason is, therefore, perceived, why it may not pass as incidental to those powers which are expressly given, if it be a direct mode of executing them.

"But the Constitution of the United States has not left the right of Congress to employ the necessary means, for the execution of the powers conferred on the government, to general reasoning. To its enumeration of powers is added that of making 'all laws which shall be necessary and proper, for carrying into execution the foregoing powers, and all other powers vested by this Constitution, in the government of the United States, or in any department thereof.'

* * * * *

"But the argument on which most reliance is placed, is drawn from the peculiar language of this clause. Congress is not empowered by it to make all laws, which may

have relation to the powers conferred on the government, but such only as may be '*necessary and proper*' for carrying them into execution. The word '*necessary*' is considered as controlling the whole sentence, and as limiting the right to pass laws for the execution of the granted powers, to such as are indispensable, and without which the power would be nugatory. That it excludes the choice of means, and leaves to Congress, in each case, that only which is most direct and simple.

"Is it true, that this is the sense in which the word 'necessary' is always used? Does it always import an absolute physical necessity, so strong, that one thing, to which another may be termed necessary, cannot exist without that other? We think it does not. If reference be had to its use, in the common affairs of the world, or in approved authors, we find that it frequently imports no more than that one thing is convenient, or useful, or essential to another. To employ the means necessary to an end, is generally understood as employing any means calculated to produce the end, and not as being confined to those single means, without which the end would be entirely unattainable. * * * A thing may be necessary, very necessary, absolutely or indispensably necessary. To no mind would the same idea be conveyed, by these several phrases. This comment on the word is well illustrated by the passage cited at the bar from the 10th section of the 1st article of the Constitution. It is, we think, impossible to compare the sentence which prohibits a State from laying 'imposts, or duties on imports or exports, except what may be *absolutely* necessary for executing its inspection laws,' with that which authorizes Congress 'to make all laws which shall be necessary and proper for carrying into execution' the powers of the general government, without feeling a conviction that the convention understood itself to change materially the meaning of the word 'necessary,' by prefixing the word 'absolutely.' This word, then, like others, is used in various senses; and, in its construction, the subject, the context, the intention of the person using them, are all to be taken into view.

"Let this be done in the case under consideration. The subject is the execution of those great powers on which the welfare of a nation essentially depends. It must have been the intention of those who gave these powers, to insure, as far as human prudence could insure, their beneficial execution. This could not be done by confiding the choice of means to such narrow limits as not to leave it in the power of Congress to adopt any which might be appropriate, and which were conducive to the end. This

provision is made in a Constitution intended to endure for ages to come, and, consequently, to be adapted to the various *crises* of human affairs. To have prescribed the means by which government should, in all future time, execute its powers, would have been to change, entirely, the character of the instrument, and give it the properties of a legal code. It would have been an unwise attempt to provide, by immutable rules, for exigencies which, if foreseen at all, must have been seen dimly, and which can be best provided for as they occur. To have declared that the best means shall not be used, but those alone without which the power given would be nugatory, would have been to deprive the legislature of the capacity to avail itself of experience, to exercise its reason, and to accommodate its legislation to circumstances. If we apply this principle of construction to any of the powers of the government, we shall find it so pernicious in its operation that we shall be compelled to discard it.

* * * * *

"So, with respect to the whole penal code of the United States: whence arises the power to punish in cases not prescribed by the Constitution? All admit that the government may, legitimately, punish any violation of its laws; and yet, this is not among the enumerated powers of Congress. The right to enforce the observance of law, by punishing its infraction, might be denied with the more plausibility, because it is expressly given in some cases. Congress is empowered 'to provide for the punishment of counterfeiting the securities and current coin of the United States,' and 'to define and punish piracies and felonies committed on the high seas, and offenses against the law of nations.' The several powers of Congress may exist, in a very imperfect state to be sure, but they may exist and be carried into execution, although no punishment should be inflicted in cases where the right to punish is not expressly given.

"Take, for example, the power 'to establish post-offices and post roads.' This power is executed by the single act of making the establishment. But, from this has been inferred the power and duty of carrying the mail along the post road, from one post-office to another. And, from this implied power, has again been inferred the right to punish those who steal letters from the post-office, or rob the mail. It may be said, with some plausibility, that the right to carry the mail, and to punish those who rob it, is not indispensably necessary to the establishment of a post-office and post road. This right is indeed essential to the beneficial exercise of the power, but not indispensably necessary to

its existence. So, of the punishment of the crimes of stealing or falsifying a record or process of a court of the United States, or of perjury in such court. To punish these offenses is certainly conducive to the due administration of justice. But courts may exist, and may decide the causes brought before them, though such crimes escape punishment.

"The baneful influence of this narrow construction on all the operations of the government, and the absolute impracticability of maintaining it without rendering the government incompetent to its great objects, might be illustrated by numerous examples drawn from the Constitution, and from our laws. The good sense of the public has pronounced, without hesitation, that the power of punishment appertains to sovereignty, and may be exercised whenever the sovereign has a right to act, as incidental to his constitutional powers. It is a means of carrying into execution all sovereign powers, and may be used, although not indispensably necessary. It is a right incidental to the power, and conducive to its beneficial exercise.

"If this limited construction of the word 'necessary' must be abandoned in order to punish, whence is derived the rule which would reinstate it, when the government would carry its powers into execution by means not vindictive in their nature? If the word 'necessary' means 'needful,' 'requisite,' 'essential,' 'conducive to,' in order to let in the power of punishment for the infraction of law; why is it not equally comprehensive when required to authorize the use of means which facilitate the execution of the powers of government without the infliction of punishment?

* * * * *

"We admit, as all must admit, that the powers of the government are limited, and that its limits are not to be transcended. But we think the sound construction of the constitution must allow to the national legislature that discretion, with respect to the means by which the powers it confers are to be carried into execution, which will enable that body to perform the high duties assigned to it, in the manner most beneficial to the people. Let the end be legitimate, let it be within the scope of the Constitution, and all means which are appropriate, which are plainly adapted to that end, which are not prohibited, but consist with the letter and spirit of the Constitution, are constitutional.

* * * * *

"If a corporation may be employed indiscriminately with other means to carry into execution the powers of

> the government, no particular reason can be assigned for excluding the use of a bank, if required for its fiscal operations. To use one must be within the discretion of Congress, if it be an appropriate mode of executing the powers of government. That it is a convenient, a useful, and essential instrument in the prosecution of its fiscal operations, is not now a subject of controversy. All those who have been concerned in the administration of our finances have concurred in representing its importance and necessity; and so strongly have they been felt, that statesmen of the first class, whose previous opinions against it had been confirmed by every circumstance which can fix the human judgment, have yielded those opinions to the exigencies of the nation. Under the confederation, Congress, justifying the measure by its necessity, transcended perhaps its powers to obtain the advantage of a bank; and our own legislation attests the universal conviction of the utility of this measure. The time has passed away when it can be necessary to enter into any discussion in order to prove the importance of this instrument, as a means to effect the legitimate objects of the government." 4 Wheat., 407-23, *passim*.

In Fleckner v. U. S. Bank, 8 Wheat. 338 (1823), the power of the bank to discount promissory notes in the course of its banking operations was upheld, and in Osborn v. U. S. Bank, 9 Wheat. 738 (1824), the decision in McCulloch v. Maryland was elaborately reviewed and affirmed. The following extracts from the opinion, also by Marshall, deal particularly with the constitutionality of the private aspects of national banking.

> "The whole opinion of the court, in the case of *McCulloch v. The State of Maryland*, is founded on, and sustained by, the idea that the bank is an instrument which is 'necessary and proper for carrying into effect the powers vested in the government of the United States.' It is not an instrument which the government found ready made, and has supposed to be adapted to its purpose; but one which was created in the form in which it now appears, for national purposes only. It is, undoubtedly, capable of transacting private as well as public business. While it is the great instrument by which the fiscal operations of the government are effected, it is also trading with individuals for its own advantage. The appellants endeavor to distinguish between this trade and its agency for the public, between its banking operations and those qualities which it possesses in common with every corporation, such as individuality, immortality, etc. While they seem

to admit the right to preserve this corporate existence, they deny the right to protect it in its trade and business.

* * * * *

"Let this distinction be considered.

"Why is it that Congress can incorporate or create a bank? This question was answered in the case of *McCulloch v. The State of Maryland.* It is an instrument which is 'necessary and proper' for carrying on the fiscal operations of government. Can this instrument, on any rational calculation, effect its object, unless it be endowed with that faculty of lending and dealing in money which is conferred by its charter? If it can, if it be as competent to the purposes of government without as with this faculty, there will be much difficulty in sustaining that essential part of the charter. If it cannot, then this faculty is necessary to the legitimate operations of government, and was constitutionally and rightfully engrafted on the institution. It is, in that view of the subject, the vital part of the corporation; it is its soul; and the right to preserve it originates in the same principle, with the right to preserve the skeleton or body which it animates. The distinction between destroying what is dominated the corporate franchise, and destroying its vivifying principle, is precisely as incapable of being maintained, as a distinction between the right to sentence a human being to death, and a right to sentence him to a total privation of sustenance during life. Deprive a bank of its trade and business, which is its sustenance, and its immortality, if it have that property, will be a very useless attribute.

"This distinction, then, has no real existence. To tax its faculties, its trade, and occupation, is to tax the bank itself. To destroy or preserve the one, is to destroy or preserve the other.

"It is urged, that Congress has not, by this act of incorporation, created the faculty of trading in money; that it had anterior existence, and may be carried on by a private individual, or company, as well as by a corporation. As this profession or business may be taxed, regulated, or restrained, when conducted by an individual, it may, likewise, be taxed, regulated, or restrained, when conducted by a corporation.

"The general correctness of these propositions need not be controverted. Their particular application to the question before the court is alone to be considered. We do not maintain that the corporate character of the bank exempts its operations from the action of state authority. If an individual were to be endowed with the same faculties, for the same purposes, he would be equally protected

in the exercise of those faculties. The operations of the bank are believed not only to yield the compensation for its services to the government, but to be essential to the performance of those services. Those operations give its value to the currency in which all the transactions of the government are conducted. They are, therefore, inseparably connected with those transactions. They enable the bank to render those services to the nation for which it was created, and are, therefore, of the very essence of its character, as national instruments. The business of the bank constitutes its capacity to perform its functions, as a machine for the money transactions of the government. Its corporate character is merely an incident, which enables it to transact that business more beneficially.

"Congress was of opinion that these faculties were necessary, to enable the bank to perform the services which are exacted from it, and for which it was created. This was certainly a question proper for the consideration of the national legislature. But, were it now to undergo revision, who would have the hardihood to say, that, without the employment of a banking capital, those services could be performed? That the exercise of these faculties greatly facilitates the fiscal operations of the government, is too obvious for controversy; and who will venture to affirm, that the suppression of them would not materially affect those operations, and essentially impair, if not totally destroy, the utility of the machine to the government? The currency which it circulates, by means of its trade with individuals, is believed to make it a more fit instrument for the purposes of government, than it could otherwise be; and, if this be true, the capacity to carry on this trade is a faculty indispensable to the character and objects of the institution.

"The appellants admit that, if this faculty be necessary to make the bank a fit instrument for the purposes of the government, Congress possesses the same power to protect the machine in this, as in its direct fiscal operations; but they deny that it is necessary to those purposes, and insist that it is granted solely for the benefit of the members of the corporation. Were this proposition to be admitted, all the consequences which are drawn from it might follow. But it is not admitted. The court has already stated its conviction, that without this capacity to trade with individuals, the bank would be a very defective instrument, when considered with a single view to its fitness for the purposes of government. On this point the whole argument rests." 9 Wheat., 860-65, *passim.*

The charter of the Second Bank of the United States was not renewed upon its expiration in 1836, and there was no further federal legislation upon the subject until it was called forth by the exigencies of the Civil War. The principal acts concerning currency and banking passed at this period were those authorizing the issue of circulating notes directly by the government (12 St. L. 259, 313, 338), later issues of which were made a legal tender for debts (12 St. L. 345, 370, 532, 710); those authorizing the formation of national banks with the power to issue notes based upon the deposit of United States bonds (12 St. L. 665; 13 Ib. 99); and the prohibitive tax of ten per cent upon the circulation of all notes other than those of the United States and of national banks (13 St. L. 484; 14 Ib. 146). Fractional currency was also issued (12 St. L. 711). All of these acts were finally upheld, upon grounds attributing to the United States a complete control over the currency of the country. Even the first legal tender case (Hepburn v. Griswold, 8 Wall. 603), which by a divided court denied that Congress could make its notes a legal tender for prior debts, contained affirmations by all the judges of the validity of government or national bank notes not a legal tender.

In Veazie Bank v. Fenno, 8 Wall. 533 (1869), the court upheld the federal tax of ten per cent upon non-federal circulating notes by the following reasoning:

> "It cannot be doubted that under the Constitution the power to provide a circulation of coin is given to Congress. And it is settled by the uniform practice of the government and by repeated decisions, that Congress may constitutionally authorize the emission of bills of credit. It is not important here to decide whether the quality of legal tender, in payment of debts, can be constitutionally imparted to these bills; it is enough to say that there can be no question of the power of the government to emit them; to make them receivable in payment of debts to itself; to fit them for use by those who see fit to use them in all the transactions of commerce; to provide for their redemption; to make them a currency, uniform in value and description, and convenient and useful for circulation. These powers, until recently, were only partially and occasionally exercised. Lately, however, they have been called into full activity, and Congress has undertaken to supply a currency for the entire country.
>
> "The methods adopted for the supply of this currency were briefly explained in the first part of this opinion. It now consists of coin, of United States notes, and

of the notes of the national banks. Both descriptions of notes may be properly described as bills of credit, for both are furnished by the government; both are issued on the credit of the government; and the government is responsible for the redemption of both; primarily as to the first description, and immediately upon default of the bank, as to the second. When these bills shall be made convertible into coin, at the will of the holder, this currency will, perhaps, satisfy the wants of the community, in respect to a circulating medium, as perfectly as any mixed currency that can be devised.

"Having thus, in the exercise of undisputed constitutional powers, undertaken to provide a currency for the whole country, it cannot be questioned that Congress may, constitutionally, secure the benefit of it to the people by appropriate legislation. To this end, Congress has denied the quality of legal tender to foreign coins, and has provided by law against the imposition of counterfeit and base coin on the community. To the same end, Congress may restrain, by suitable enactments, the circulation as money of any notes not issued under its own authority. Without this power, indeed, its attempts to secure a sound and uniform currency for the country must be futile." 8 Wall., 548-49.

In Hepburn v. Griswold, 8 Wall. 603 (1870), the majority of the court said:

"Let it be considered what has actually been done in the provision of a national currency. In July and August, 1861, and February, 1862, the issue of sixty millions of dollars in United States notes, payable on demand, was authorized. (12 Stat. at Large, 259, 313, and 338.) They were made receivable in payments, but were not declared a legal tender until March, 1862 (12 Stat. at Large, 370), when the amount in circulation had been greatly reduced by receipt and cancellation. In 1862 and 1863 (12 Stat. at Large, 345, 532 and 709) the issue of four hundred and fifty millions in the United States notes, payable not on demand, but, in effect, at the convenience of the government, was authorized, subject to certain restrictions as to fifty millions. These notes were made receivable for the bonds of the national loans, for all debts due to or from the United States, except duties on imports and interest on the public debt, and were also declared a legal tender. In March, 1863 (12 Stat. at Large, 711), the issue of notes for parts of a dollar was authorized to an amount not exceeding fifty millions of dollars. These notes were not declared a legal tender, but were made redeemable under regulations to be prescribed by the secretary of the treas-

ury. In February, 1863 (12 Stat. at Large, 669), the issue of three hundred millions of dollars in notes of the national banking associations was authorized. These notes were made receivable to the same extent as United States notes, and provision was made to secure their redemption, but they were not made a legal tender.

"The several descriptions of notes have since constituted, under the various acts of Congress, the common currency of the United States.

* * * * *

"No one questions the general constitutionality, and not very many, perhaps, the general expediency of the legislation by which a note currency has been authorized in recent years. The doubt is as to the power to declare a particular class of these notes to be a legal tender in payment of pre-existing debts." 8 Wall., 618-19.

This doubt the majority decided against the existence of the power, and were overruled a year later in the Legal Tender Cases, 12 Wall. 457 (1871). Mr. Justice Strong, giving the opinion of the court in this case, said:

"It may be conceded that Congress is not authorized to enact laws in furtherance even of a legitimate end, merely because they are useful, or because they make the government stronger. There must be some relation between the means and the end; some adaptedness or appropriateness of the laws to carry into execution the powers created by the Constitution. But when a statute has proved effective in the execution of powers confessedly existing, it is not too much to say that it must have had some appropriateness to the execution of those powers. The rules of construction heretofore adopted do not demand that the relationship between the means and the end shall be direct and immediate. Illustrations of this may be found in several of the cases above cited. The charter of a bank of the United States, the priority given to debts due the government over private debts, and the exemption of Federal loans from liability to state taxation, are only a few of the many which might be given. The case of *Veazie Bank v. Fenno* (8 Wall., 533) presents a suggestive illustration. There a tax of ten per cent on state bank notes in circulation was held constitutional, not merely because it was a means of raising revenue, but as an instrument to put out of existence such a circulation in competition with notes issued by the government. There, this court, speaking through the Chief Justice, avowed that it is the constitutional right of Congress to provide a currency for the whole country; that this might be done by coin, or United States notes, or notes of national banks;

and that it cannot be questioned Congress may constitutionally secure the benefit of such a currency to the people by appropriate legislation. It was said there can be no question of the power of this government to emit bills of credit; to make them receivable in payment of debts to itself; to fit them for use by those who see fit to use them in all the transactions of commerce; to make them a currency uniform in value and description, and convenient and useful for circulation. Here the substantive power to tax was allowed to be employed for improving the currency. It is not easy to see why, if state banks notes can be taxed out of existence for the purposes of indirectly making United States notes more convenient and useful for commercial purposes, the same end may not be secured directly by making them a legal tender." 12 Wall., 543-44.

Mr. Justice Bradley in his concurring opinion said:

"Another ground of the power to issue treasury notes or bills is the necessity of providing a proper currency for the country, and especially of providing for the failure or disappearance of the ordinary currency in times of financial pressure and threatened collapse of commercial credit. Currency is a national necessity. The operations of the government, as well as private transactions, are wholly dependent upon it. The state governments are prohibited from making money or issuing bills. Uniformity of money was one of the objects of the Constitution. The coinage of money and regulation of its value is conferred upon the general government exclusively. That government has also the power to issue bills. It follows, as a matter of necessity, as a consequence of these various provisions, that it is specially the duty of the general government to provide a national currency. The states cannot do it, except by the charter of local banks, and that remedy, if strictly legitimate and constitutional, is inadequate, fluctuating, uncertain, and insecure, and operates with all the partiality to local interests which it was the very object of the Constitution to avoid. But regarded as a duty of the general government, it is strictly in accordance with the spirit of the Constitution, as well as in line with the national necessities." 12 Wall., 562-63.

After the resumption of specie payments by the United States in 1879, Congress authorized the perpetual reissue of such legal tender notes as should be paid by the government. This also was upheld in Julliard v. Greenman, 110 U. S. 421 (1884), which contains the last elaborate discussion of the fiscal and monetary powers of the government. Some extracts from the opinion by

Mr. Justice Gray will show the breadth of the powers attributed to the government.

> "The breadth and comprehensiveness of the words of the Constitution are nowhere more strikingly exhibited than in regard to the powers over the subjects of revenue, finance, and currency, of which there is no other express grant than may be found in these few brief clauses:
>
> '*The Congress shall have power*
>
> '*To lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts and excises shall be uniform throughout the United States;*
>
> '*To borrow money on the credit of the United States;*
>
> '*To regulate commerce with foreign nations, and among the several States, and with the Indian tribes;*
>
> '*To coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures.*'" 110 U. S. at 439.
>
> * * * * *
>
> "The words 'to borrow money,' as used in the Constitution, to designate a power vested in the national government, for the safety and welfare of the whole people, are not to receive that limited and restricted interpretation and meaning which they would have in a penal statute, or in an authority conferred, by law or by contract, upon trustees or agents for private purposes.
>
> "The power 'to borrow money on the credit of the United States' is the power to raise money for the public use on a pledge of the public credit, and may be exercised to meet either present or anticipated expenses and liabilities of the government. It includes the power to issue, in return for the money borrowed, the obligations of the United States in any appropriate form, of stock, bonds, bills or notes; and in whatever form they are issued, being instruments of the national government, they are exempt from taxation by the governments of the several States. *Weston v. Charleston City Council*, 2 Pet. 449; *Banks v. Mayor*, 7 Wall. 16; *Bank v. Supervisors*, 7 Wall. 26. Congress has authority to issue these obligations in a form adapted to circulation from hand to hand in the ordinary transactions of commerce and business. In order to promote and facilitate such circulation, to adapt them to use as currency, and to make them more current in the market, it may provide for their redemption in coin or bonds, and may make them receivable in payment of debts to the government. So much is settled beyond doubt, and was asserted or distinctly admitted by the judges who

dissented from the decision in the *Legal Tender Cases*, as well as by those who concurred in that decision. *Veazie Bank v. Fenno*, 8 Wall. 533, 548; *Hepburn v. Griswold*, 8 Wall. 616, 636; *Legal Tender Cases*, 12 Wall. 543, 544, 560, 582, 610, 613, 637.

"It is equally well settled that Congress has the power to incorporate national banks with the capacity, for their own profit as well as for the use of the government in its money transactions, of issuing bills which under ordinary circumstances pass from hand to hand as money as their nominal value, and which, when so current, the law has always recognized as a good tender in payment of money debts, unless specifically objected to at the time of the tender. *United States Bank v. Bank of Georgia*, 10 Wheat. 333, 347; *Ward v. Smith*, 7 Wall. 447, 451. The power of Congress to charter a bank was maintained in *McCulloch v. Maryland*, 4 Wheat. 316, and in *Osborn v. United States Bank*, 9 Wheat. 738, chiefly upon the ground that it was an appropriate means for carrying on the money transactions of the government. But Chief Justice Marshall said:

" 'The currency which it circulates, by means of its trade with individuals, is believed to make it a more fit instrument for the purposes of government than it could otherwise be; and if this be true, the capacity to carry on this trade is a faculty indispensable to the character and objects of the institution.' 9 Wheat. 864. And Mr. Justice Johnson, who concurred with the rest of the court in upholding the power to incorporate a bank, gave the further reason that it tended to give effect to 'that power over the currency of the country which the framers of the Constitution evidently intended to give to Congress alone.' Ib. 873.

"The constitutional authority of Congress to provide a currency for the whole country is now firmly established. In *Veazie Bank v. Fenno*, 8 Wall. 533, 548, Chief Justice Chase, in delivering the opinion of the court, said: 'It cannot be doubted that under the Constitution the power to provide a circulation of coin is given to Congress. And it is settled by the uniform practice of the government, and by repeated decisions, that Congress may constitutionally authorize the emission of bills of credit.' Congress, having undertaken to supply a national currency, consisting of coin, of treasury notes of the United States, and of the bills of national banks, is authorized to impose on all state banks, or national banks, or private bankers, paying out the notes of individuals or of state banks, a tax of ten per cent upon the amount of such notes so paid out. *Veazie Bank v. Fenno*, above cited; *National Bank v. United States*, 101 U. S. 1.

"It appears to us to follow, as a logical and necessary consequence, that Congress has the power to issue the obligations of the United States in such form, and to impress upon them such qualities as currency for the purchase of merchandise and the payment of debts, as accord with the usage of sovereign governments. The power, as incident to the power of borrowing money and issuing bills or notes of the government for money borrowed, of impressing upon those bills or notes the quality of being a legal tender for the payment of private debts, was a power universally understood to belong to sovereignty, in Europe and America, at the time of the framing and adoption of the Constitution of the United States.

* * * * *

"The power of issuing bills of credit, and making them, at the discretion of the legislature, a tender in payment of private debts, had long been exercised in this country by the several colonies and states; and during the Revolutionary War the states, upon the recommendation of the Congress of the Confederation, had made the bills issued by Congress a legal tender. See *Craig v. Missouri*, 4 Pet. 435, 453; *Briscoe v. Bank of Kentucky*, 11 Pet. 257, 313, 334-336; *Legal Tender Cases*, 12 Wall. 557, 558, 622; Phillips on American Paper Currency, *passim*. The exercise of this power not being prohibited to Congress by the Constitution, it is included in the power expressly granted to borrow money on the credit of the United States.

"This position is fortified by the fact that Congress is vested with the exclusive exercise of the analogous power of coining money and regulating the value of domestic and foreign coin, and also with the paramount power of regulating foreign and interstate commerce. Under the power to borrow money on the credit of the United States, and to issue circulating notes for the money borrowed, its power to define the quality and force of those notes as currency is as broad as the like power over a metallic currency under the power to coin money and to regulate the value thereof. Under the two powers, taken together, Congress is authorized to establish a national currency, either in coin or in paper, and to make that currency lawful money for all purposes, as regards the national government or private individuals.

* * * * *

"Congress, as the legislature of a sovereign nation, being expressly empowered by the Constitution 'to lay and collect taxes, to pay the debts and provide for the common defense and general welfare of the United States,' and 'to borrow money on the credit of the United States,' and 'to

coin money and regulate the value thereof and of foreign coin;' and being clearly authorized, as incidental to the exercise of those great powers, to emit bills of credit, to charter national banks, and to provide a national currency for the whole people, in the form of coin, treasury notes, and national bank bills; and the power to make the notes of the government a legal tender in payment of private debts being one of the powers belonging to sovereignty in other civilized nations, and not expressly withheld from Congress by the Constitution; we are irresistibly impelled to the conclusion that the impressing upon the treasury notes of the United States the quality of being a legal tender in payment of private debts is an appropriate means, conducive and plainly adapted to the execution of the undoubted powers of Congress, consistent with the letter and spirit of the Constitution, and therefore, within the meaning of that instrument, 'necessary and proper for carrying into execution the powers vested by this Constitution in the government of the United States.'

"Such being our conclusion in matter of law, the question whether at any particular time, in war or in peace, the exigency is such, by reason of unusual and pressing demands on the resources of the government, or of the inadequacy of the supply of gold and silver coin to furnish the currency needed for the uses of the government and of the people, that it is, as a matter of fact, wise and expedient to resort to this means, is a political question to be determined by Congress when the question of exigency arises, and not a judicial question to be afterwards passed upon by the courts." 110 U. S. 444-50, *passim.*

As regards the National Bank Act the Supreme Court has said, upon occasion:

"The constitutionality of the act of 1864 is not questioned. It rests on the same principle as the act creating the Second Bank of the United States. The reasoning of Secretary Hamilton and of this court in *McCulloch v. Maryland* (4 Wheat. 316) and in *Osborne v. The Bank of the United States* (9 Ib. 738), therefore, applies. The national banks organized under the act are instruments designed to be used to aid the government in the administration of an important branch of the public service. They are means appropriate to that end. Of the degree of the necessity which existed for creating them Congress is the sole judge.

"Being such means, brought into existence for this purpose, and intended to be so employed, the states can exercise no control over them, nor in anywise affect their operation, except in so far as Congress may see proper

to permit." *Farmers', etc., Nat. Bank v. Dearing*, 91 U. S. 29, 33-34 (1875).

"The object of the law was to establish a system of national banking institutions, in order to provide a uniform and secure currency for the people, and to facilitate the operations of the Treasury of the United States. The capital of each of the banks in this system was to be furnished entirely by private individuals; but, for the protection of the government and the people, it was required that this capital, so far as it was the security for its circulating notes, should be invested in the bonds of the United States. These bonds were not subjects of taxation; and neither the banks themselves, nor their capital, however invested, nor the shares of stock therein held by individuals, could be taxed by the States in which they were located without the consent of Congress, being exempted from the power of the states in this respect, because these banks were means and agencies established by Congress in execution of the powers of the government of the United States.

* * * * *

"The business of banking, as defined by law and custom, consists in the issue of notes payable on demand, intended to circulate as money where the banks are banks of issue; in receiving deposits payable on demand; in discounting commercial paper; making loans of money on collateral security; buying and selling bills of exchange; negotiating loans, and dealing in negotiable securities issued by the government, state and national, and municipal and other corporations. These are the operations in which the capital invested in national banks is employed." *Mercantile Bank v. New York*, 121 U. S. 138, 154, 156 (1887).

And, so completely have the national objects of these corporations drawn all of their incidents within the national control, that not only may they not be taxed against the will of Congress, but the states may not prescribe, against such will, the interest national banks may take upon loans and discounts (Tiffany v. Nat. Bank, 18 Wall. 409—1873), the penalties for usury (Farmers' etc., Bank v. Dearing, 91 U. S. 29—1875), the order of distribution of assets among depositors in case of insolvency (Davis v. Elmira Sav. Bank, 161 U. S. 275—1896), nor even penalize national bank officers for accepting deposits after knowledge of the bank's insolvency (Easton v. Iowa, 188 U. S. 220—1903).

This review of the legislation and decisions of the United States upon monetary matters for the past 120 years has been some-

what extended in order that the precise character of the reasoning by which the Supreme Court has upheld the federal banking and currency acts may be fully appreciated. The earlier decisions placed them principally upon the express powers to tax and disburse, to borrow, and to regulate interstate and foreign commerce. The later decisions, while also relying upon these—and particularly upon the power to borrow—have tended especially to emphasize the power to regulate the currency as being so clearly implied from a group of powers as to be virtually itself one of the substantive powers conferred upon Congress by the Constitution, exercisable for its own independent benefits to the nation, and no longer a mere incident to other powers (or, perhaps, so inextricably connected with various express powers that its exercise necessarily involves them). The acts authorizing the creation of our present national banking system were originally entitled "Acts to provide a National Currency" (12 Stat. 665, Feb. 25, 1863; 13 Stat. 99, June 3, 1864), and the name was not changed to the "National Bank Act" until 1874 (18 Stat. 123, c. 343, § 1). If, then, the statements to this effect frequently made by the Supreme Court since the Civil War are to be accepted as part of the *ratio decidendi* of the cases in which they occur, there can be no doubt of the constitutionality of the plan of banking and currency reform proposed by the National Citizens' League. That plan outlines a scheme for regulating the currency that is certainly well within a permissible legislative discretion in the choice of means, as defined in McCulloch v. Maryland and the Legal Tender Cases quoted above. The principal novel features of the plan, a bank of issue whose stock shall be held solely by banks of deposit, and a note issue based in large part upon bankable assets instead of national bonds, clearly bear a reasonable relation to the control of the currency in the interest of trade, industry, and investment generally throughout the country, and no incidental feature of the plan is inconsistent therewith. That stock in the proposed bank of issue, the National Reserve Association, may be held by state as well as by national banks of deposit, is of course a detail for the discretion of Congress. The character of the shareholders in an institution charged with important public functions is preëminently a matter for legislative prescription.

Despite the many assertions by the Supreme Court, however, of an unqualified national power to regulate the currency, it may

be doubted whether such statements were really necessary to the decision in any case that has been before the court. All of our previous banking and currency systems may be readily sustained as incidental to the exercise of other express powers, like those of taxing, borrowing, regulating commerce, carrying on war, and so forth. It is worthy of consideration, therefore, whether the proposed system is also referable to the exercise of these powers.

The proposed plan contemplates that the National Reserve Association shall act as the fiscal agent of the federal government, receiving all of its cash receipts and acting as a channel for all of its disbursements. These proposals, if adopted, appear to bring the entire plan within the reasoning of McCulloch v. Maryland, as incidental to the powers of collecting and disbursing revenue. Even if they be not adopted *in toto,* but merely to the extent of the present practice of making national banks depositaries of certain government balances, this alone would seem to relate the system to the fiscal operations of the government sufficiently to sustain it, when due regard is had to the general usages of governments in such matters. The complete withdrawal from circulation of a large and rapidly fluctuating government balance of current money is such an unmixed evil to business that the provision of a banking system solely to escape this would be properly incidental to the collection of revenue.

The earlier and present banking systems of the United States could be sustained as incidental to the national borrowing power. Three-fourths of the private subscription of $8,000,000 to the first Bank of the United States was required to be paid in in certificates of the public debt of the United States, and three-fourths of the private subscription of $28,000,000 to the second Bank might be paid in similar certificates at rates that doubtless invited the choice of this alternative rather than cash. The original national bank acts of 1863 and 1864 required one-third of the capital of each bank to be invested in United States bonds which were deposited with the United States as a basis for a note issue of ninety per cent of the market value of such bonds. This was later changed to require only one-fourth of the capital of banks capitalized at less than $150,000 to be thus invested, and a minimum of $50,000 from larger banks (18 Stat. 124, § 4). In 1900 the issue of notes was permitted up to the par value of the bonds deposited, if the market value was at least this much (13 Stat. 49, § 12). All of

these provisions greatly facilitated the borrowing operations of the government, widening the market for its bonds and reducing the rate of interest, so that the two per cent gold bonds of recent years upon which a bank note circulation could be based have sold at par, while similar bonds without such a provision would have fallen many points below in the market. From the two early Banks of the United States the government also borrowed large sums directly upon short-time loans, this being one of Hamilton's purposes in chartering the first Bank.

Under the proposed plan the National Reserve Association will, at the option of the national banks, purchase their government bonds deposited to secure circulation and assume responsibility for the notes secured thereby. Any note circulation, thereafter withdrawn by a national bank shall not be reissued, and, as rapidly as possible, the present bond-secured circulation shall be withdrawn and replaced by notes of the National Reserve Association, secured one-third by gold, and the remainder by United States bonds, bankable commercial paper, or other kinds of money. The United States bonds thus purchased, the Association is to hold for not less than ten years, except that, with the approval of the Secretary of the Treasury, it may after two years dispose annually of $50,000,000 of such bonds. There are at present over $700,000,000 of bank note currency secured by United States bonds, so that it would be possible for all of these bonds to be disposed of in sixteen or seventeen years, after which the notes of the Association would be chiefly secured by gold or bankable paper, and the existence of this currency would no longer directly affect the marketability or interest rate of United States bonds. After this period, could the Association be justly considered an instrumentality in aid of the federal borrowing power?

It seems that at least two arguments might properly be urged in support of this proposition. In the first place, the proposed Association with its large reserves of fluid capital would be an extremely valuable source from which to procure large short-time loans in emergencies, as well as to provide an investment medium for taking large blocks of future government bond issues that might not find an immediate popular market; and it is expressly authorized to invest in both of these government securities. It is obviously unsafe to assume that such emergencies as have confronted former generations will never arise in our own or future

times, and a large bank that is a going concern is a much more adequate financial instrument in an emergency than one can be that is extemporized for the occasion. Our present national banking system that sprang from the necessities of war did not get into good working condition until the war was over. One can only conjecture what the government might have saved had it had such a fiscal organization ready at hand when the great strain upon its credit began. For instance, suppose, after the proposed Association had disposed of most of the bonds now deposited to secure note circulation, that the government in an emergency should need to market a large issue of new bonds at a favorable rate. A statute requiring a certain proportion of the future note issues of the Association to be based on these new bonds would at once have the same stimulating effect upon the national credit as did the original provisions of the present currency system. The Association plan therefore seems sustainable under the federal borrowing power as a provision for future emergencies, and this was Hamilton's view.

Leading to the same conclusion is another line of reasoning, more cogent and immediate, also based upon the borrowing power. The United States has now outstanding over $346,000,000 of its own legal tender notes, the greenbacks, whose continued reissue was upheld in Julliard v. Greenman, 110 U. S. 421 (1884), quoted above. These, when issued, were aptly described as constituting a forced loan from government creditors, and their issue was assumed in the various legal tender cases to rest, in part at least, upon the national borrowing power. It has been the policy of the government, as well as its plain duty, to redeem these in gold, upon presentation to the Treasury, ever since specie payments were resumed in 1879, and this is now compulsory by statute (31 Stat. 45, c. 343, § 2). A redemption fund of $150,000,000 in gold is now maintained for this purpose, and the same statute provides that, should it fall below $100,000,000 in amount, on account of excessive redemptions that cannot be made good by the purchase of other gold with the notes thus redeemed, the United States shall issue bonds for gold to restore this fund to its maximum of $150,000,000. Moreover, the same statute (§1) expressly adopts the gold standard for the United States and makes it the duty of the Secretary of the Treasury to maintain all money issued or coined by the government at a parity of value with this standard. In practice this can only be done when other forms of money may be

readily converted into gold at par; so that the United States is really undertaking to keep at a parity with gold, not only $346,000,000 of its own notes, but over $500,000,000 of silver dollars (actually worth about 40 per cent of their face value), to say nothing of over $150,000,000 of subsidiary silver. This task the United States undertakes in regard to its notes as incidental to its borrowing power, and in regard to its coin under the express power to coin money and regulate the value thereof.

If the control of the entire currency of the country, and the regulation of its volume, security, mode of issue, flexibility, and so forth, may have any substantial effect upon the government's efforts to keep all of its money at par with gold, then the United States may create a banking system whose note issues need not be based upon government bonds, but may be secured by gold, commercial paper, industrial, public utility, or municipal bonds, or indeed any form of assets approved by the discretion of Congress. The utility of such a plan, especially in seasons of commercial panic, when supported by the combined resources of the banks throughout a considerable territory or in important commercial cities, was demonstrated during the panic of 1907, and it is now authorized by the act of May 30, 1908 (35 Stat. 546), whenever in the judgment of the Secretary of the Treasury local business conditions demand additional circulation. This act, which provides for the voluntary formation of "national currency associations" by at least ten national banks in contiguous territory having a combined capital and surplus of at least $5,000,000, permits a note issue to such associations to the extent of seventy-five per cent of the cash value of approved securities transferred to the association by its members on whose behalf the issue is made. The securities thus deposited are held in trust for the use of the United States in redeeming the notes based thereon, and all of the constituent banks of each association are also liable to the United States for the redemption of all notes thus issued to their association. The necessity and amount of such note issues and the character of the securities upon which they are based are left to the approval of the Secretary of the Treasury.

So far as constitutional objections are concerned, this statute of 1908 seems to differ in no essential particulars from the proposed plan of the National Reserve Association. The latter contemplates the formation of those banks that comply with certain

standard requirements into local associations. The same banks also become shareholders in the National Reserve Association. The National Association will rediscount for its members approved thirty-day commercial paper, and will also rediscount approved four-months paper which has been guaranteed by the local Association to which the holder of the paper belongs. It may issue notes for such paper rediscounted by it, but all of its demand liabilities, whether in the form of notes or deposits, are to be secured by a thirty-three per cent gold reserve and the remainder by government bonds, bankable commercial paper, or other kinds of money. If Congress sees fit to authorize a national bank currency based in part upon commercial assets as a regular procedure instead of as an emergency measure, this, as has often been said, is a political question upon which the decision of Congress is final. It certainly cannot be said that such a measure bears no rational relation to the government's obligation to keep all its money at a parity at all times.

In discussing the validity of national banking and currency legislation, the Supreme Court has usually mentioned the federal power to regulate foreign and interstate commerce as also a justification of such legislation, though the argument based upon this power has never been judicially elaborated as have those based upon the taxing and borrowing powers. It was one of Hamilton's principal arguments, however, and in the last legal tender case (Julliard v. Greenman, 110 U. S. 421—1884) the commercial power was enumerated by the court as one of those upon which rested the government's powers over revenue, finance, and the currency. (Ib. 439.) Of course, if the federal power over the currency can be referred to its commercial powers, there cannot be the slightest doubt of the constitutionality of the proposed National Reserve Association, for nothing can more intimately affect commerce than the medium of exchange. A strong argument can certainly be made to this effect, though at present it lacks explicit confirmation in the decided cases.

Commerce has been judicially defined as *intercourse,* and interstate and foreign commerce is intercourse, at least for business purposes, between the states or with foreign countries. This intercourse may consist of the transit of persons, of goods, or of intelligence, and those activities which are necessarily or customarily connected with such transit, though they may precede or follow it, are incidentally included within the general grant of commercial power.

Thus, the soliciting in one state of sales of goods to be shipped in from another state, or of passengers and freight to be shipped out to other states, is a part of interstate commerce (Robbins v. Shelby Co. Dist. 120 U. S. 489; McCall v. California, 136 U. S. 104); as is the subsequent sale in a state of goods shipped into it for this purpose (Leisy v. Hardin, 135 U. S. 100). The argument has been that such transits would not readily take place unless they could be solicited or contracted for, or unless the objects of the transit could be disposed of after arrival in the state of their destination, and therefore these activities are within the control of Congress as incidental to the transit itself.

Many of the most important statutes recently passed by Congress are concerned with matters incidental to interstate or foreign commerce. Congress has thus regulated the use of trademarks in such commerce (33 Stat. 724—1905); the preparation and labeling of food and drugs that become a part of such commerce (34 Stat. 768—1906); the use of safety appliances upon railroads engaged in such commerce (27 Stat. 531—1893; Johnson v. So. Pac. Co., 196 U. S. 1); the hours of labor of employees of carriers engaged in such commerce (34 Stat. 1415—1907); the mode of payment of wages of seamen in such commerce (30 Stat. 763, § 24—1898; Patterson v. Eudora, 190 U. S. 169); and the liability of railroads for injuries to employees engaged in such commerce (34 Stat. 415—1908; Employers' Liability Cases, 207 U. S. 463; Mondon v. New York, etc., Ry., U. S. Sup. Ct., Jan. 15, 1912). Congress may also provide facilities for such commerce, as by chartering interstate railroad or bridge companies, with powers of eminent domain, or by constructing interstate highways directly itself (Luxton v. North River Bridge Co., 153 U. S. 525). Of course, Congress may regulate the purely internal commerce of a state whenever it is so intimately connected with interstate commerce that both must be regulated to secure the desired results for the latter (Southern Ry. v. U. S., 222 U. S. 20, — 1911).

Within the principle of the legislation just mentioned it would seem that Congress might also regulate the currency of the country, directly or through a national banking system, as incidental to interstate trade which is vitally concerned with its medium of exchange, and might provide or authorize the provision of a national currency to facilitate interstate and foreign trade. If the Supreme Court has not tacitly assumed this on various occasions,

it is difficult to understand the meaning of its references to the commercial power as among those upon which the federal control of banking and currency rests.

To the possible objection that the proposed act would create a virtual partnership between the government and the shareholders in the National Reserve Association, it may be pointed out that, in the two old United States Banks of 1791 and 1816, the government actually invested one-fifth of the authorized capital, and that no objection to this particular feature was suggested by either court or counsel, assuming the general constitutionality of a national bank. But in the present plan the government invests nothing and is merely given a share of the profits above four per cent, which may more aptly be described as a species of franchise tax on earnings above this amount, than as a partnership. Similarly the city of Chicago receives the larger share of the earnings of its street railway companies above five per cent, but no one imagines that this is legally or constitutionally objectionable. It is part of the price for the franchises of such companies, and the like exaction by the United States from the National Reserve Association should be similarly regarded.

I should therefore advise that an act of Congress constituting a National Reserve Association with an organization and powers substantially as indicated in the proposals submitted to me for opinion would be constitutional, under any or all of Congress's express powers to raise and spend revenue, to borrow money, to coin money and to regulate the value thereof, or to regulate interstate and foreign commerce.

APPENDIX

THE NATIONAL CITIZENS' LEAGUE

The National Citizens' League for the Promotion of a Sound Banking System is incorporated under the laws of Illinois. The panic of 1907 caused general concern for the commercial safety of the future and pointed the necessity of immediate revision of our banking and monetary system. As one of the manifestations of this general concern The National Board of Trade, at its meeting in Washington in January, 1910, adopted resolutions favoring a revision of the currency system and calling upon its constituent bodies to "study the fundamental principles of banking and currency, in order to intelligently aid the enactment of such legislation as will best conserve the interests of the entire country." At the same meeting January 18 of the year following was set aside as "monetary day," to be devoted to a "Business Men's Monetary Conference."

At this conference in January, 1911, the Chairman was authorized to appoint a committee to organize a "Business Men's Monetary Reform League," with headquarters in Chicago and branches throughout the country, to conduct a comprehensive campaign of education in behalf of some kind of a national reserve association.

This committee met in Chicago April 26, 1911. A number of conferences were held and a plan of campaign considered. At the same time the Chicago Association of Commerce passed the following resolution:

"*Resolved*, That the Chicago Association of Commerce, recognizing the distressing effects of panics on trade, capital and labor, the consequent need of a sound banking system in the interest of all the people in the country, and the suggestion made for the creation of a National Reserve Association, hereby requests John G. Shedd, Marvin Hughitt, Graham Taylor, Harry A. Wheeler, B. E. Sunny, Cyrus H. McCormick, Julius Rosenwald, Charles H. Wacker, Frederic A. Delano, John Barton Payne, A. C. Bartlett, A. A.

Sprague, J. Laurence Laughlin, John V. Farwell, Clyde M. Carr, Fred W. Upham, F. H. Armstrong, and Joseph Basch to form a National Citizens' League, the object of which shall be to give organized expression to the growing public sentiment in favor of, and to aid in securing the legislation necessary to insure an improved banking system for the United States of America."

The National Citizens' League was the result of these efforts. It is a non-partisan, non-political organization, interested only to disseminate accurate information and induce right thinking and a thorough understanding of the problems of banking and currency. It has organizations in 44 states. It has no reform plan of its own, but offers as the objects to be attained by the reform, the following:

1. Coöperation, not dominant centralization, of all banks by an evolution out of our clearing-house experience.

2. Protection of the credit system of the country from the domination of any group of financial or political interests.

3. Independence of the individual banks, national or state, and uniform treatment in discounts and rates to all banks, large or small.

4. Provision for making liquid the sound commercial paper of all the banks, either in the form of credits or banknotes redeemable in gold or lawful money.

5. Elasticity of currency and credit in times of seasonal demands and stringencies, with full protection against over-expansion.

6. Legalization of acceptances of time bills of exchange, in order to create a discount market at home and abroad.

7. The organization of better banking facilities with other countries, to aid in the extension of our foreign trade.

The officers and directors of the League are:

IN CHICAGO

President, JOHN V. FARWELL
Vice-President, JOHN BARTON PAYNE
Chairman of Executive Committee, J. LAURENCE LAUGHLIN
Treasurer, A. C. BARTLETT
Secretary of Organization, M. S. WILDMAN

B. E. SUNNY
JULIUS ROSENWALD
CYRUS H. MCCORMICK
A. A. SPRAGUE
HARRY A. WHEELER
CLYDE M. CARR
JOHN G. SHEDD
F. H. ARMSTRONG
F. A. DELANO
GRAHAM TAYLOR
F. W. UPHAM
C. H. WACKER
MARVIN HUGHITT
JOSEPH BASCH

IN THE STATES

Alabama, JOHN L. KAUL, Birmingham
Arizona, HUGO J. DONAU, Tucson
Arkansas, F. B. T. HOLLENBERG, Little Rock
North California, CHARLES H. BENTLEY, San Francisco
South California, J. OTTO KOEPFLI, Los Angeles
Colorado, CHARLES MAC A. WILLCOX, Denver
Connecticut, FRANK CHENEY, JR., Manchester
Delaware, THOMAS F. BAYARD, Wilmington
Florida, ROBERT V. COVINGTON, Jacksonville
Georgia, J. K. ORR, Atlanta
Idaho, C. O. DAVIDSON, Boise
Illinois, U. G. ORENDORFF, Canton
Indiana, L. C. BOYD, Indianapolis
Iowa, ROBERT J. FLEMING, Des Moines
Kansas, CHARLES M. HARGER, Abilene
Kentucky, JOHN M. ATHERTON, Louisville
Louisiana, CRAWFORD H. ELLIS, New Orleans
Maine, FRED E. RICHARDS, Portland
Maryland, GEORGE CATOR, Baltimore
Massachusetts, WM. L. DOUGLAS, Brockton
Michigan, JOSEPH L. HUDSON, Detroit
Minnesota, JOHN H. RICH, Red Wing
Mississippi, C. H. WILLIAMS, Yazoo City
Missouri, GEORGE A. MAHAN, Hannibal
Montana, NORMAN B. HOLTER, Helena
Nebraska, A. E. CADY, St. Paul
New Hampshire, ALVAH W. SULLOWAY, Franklin
New Jersey, FRANKLIN MURPHY, Newark
New Mexico, HERBERT J. HAGERMAN, Roswell
New York, JOHN CLAFLIN, New York City
North Dakota, L. B. HANNA, Fargo
Ohio, JAMES ALBERT GREEN, Cincinnati
Oklahoma, FRED S. GUM, Oklahoma City
Oregon, THOMAS D. HONEYMAN, Portland
Pennsylvania, C. STUART PATTERSON, Philadelphia
Rhode Island, JAMES R. MACCOLL, Pawtucket
South Carolina, LEWIS W. PARKER, Greenville
South Dakota, T. HENRY FOSTER, Sioux Falls
Tennessee, WHITEFOORD R. COLE, Nashville
Texas, ROBERT J. KLEBERG, Kingsville
Utah, JOY H. JOHNSON, Salt Lake City
Virginia, WILLIAM E. CARSON, Riverton
Washington, JAMES S. GOLDSMITH, Seattle
Wisconsin, W. H. HATTON, New London
Wyoming, A. D. KELLEY, Cheyenne
German Division, CHARLES H. STEINWAY, New York

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